

08-916

JAN 21 2009

No. 08- OFFICE OF THE CLERK

---

IN THE  
**Supreme Court of the United States**

---

VFJ VENTURES, INC., F/K/A VF JEANSWEAR, INC.,  
*Petitioner,*

v.

G. THOMAS SURTEES, IN HIS OFFICIAL CAPACITY AS  
COMMISSIONER OF THE DEPARTMENT OF REVENUE  
FOR THE STATE OF ALABAMA, AND THE  
ALABAMA DEPARTMENT OF REVENUE,  
*Respondents.*

---

**On Petition for a Writ of Certiorari  
to the Supreme Court of Alabama**

---

**PETITION FOR A WRIT OF CERTIORARI**

---

KEVIN C. NEWSOM  
JOHN C. NEIMAN, JR.  
BRADLEY ARANT BOULT  
CUMMINGS LLP  
One Federal Place  
1819 Fifth Avenue North  
Birmingham, AL 35203  
(205) 521-8000

CARTER G. PHILLIPS\*  
PAUL J. ZIDLICKY  
MATTHEW D. KRUEGER  
SIDLEY AUSTIN LLP  
1501 K Street, N.W.  
Washington, D.C. 20005  
(202) 736-8000

*Counsel for Petitioner*

January 21, 2009

\* Counsel of Record

## QUESTIONS PRESENTED

1. Whether the State of Alabama's "add-back" statute discriminates against interstate commerce in violation of the Commerce Clause by denying a deduction for ordinary business expenses because they are paid to corporations located outside Alabama in a State that has chosen not to tax those payments.

2. Whether Alabama's "add-back" statute violates the Due Process and Commerce Clauses by denying a deduction for ordinary business expenses paid to corporations located outside Alabama based on the tax policy of the State in which those corporations are located.

## LIST OF PARTIES AND AFFILIATES

Petitioner is VFJ Ventures, Inc., f/k/a VF Jeanswear, Inc. Respondents are G. Thomas Surtees, in his official capacity as Commissioner of the Department of Revenue for the State of Alabama, and the Alabama Department of Revenue.

Pursuant to Rule 29.6 of the Rules of this Court, VFJ Ventures, Inc. discloses that it is a wholly owned subsidiary of Wrangler Apparel Corp., which is a wholly owned subsidiary of Ring Company, which, in turn, is a wholly owned subsidiary of V.F. Corporation, which is a publicly traded company. PNC Bank, N.A., owns more than 10% of V.F. Corporation's stock. PNC Bank, N.A., is owned by The PNC Financial Services Group, Inc., which is a publicly traded company.

## TABLE OF CONTENTS

|  | Page |
|--|------|
| QUESTIONS PRESENTED .....  | i    |
| LIST OF PARTIES AND AFFILIATES.....  | ii   |
| TABLE OF AUTHORITIES .....   | v    |
| OPINIONS BELOW .....   | 1    |
| JURISDICTION.....  | 1    |
| CONSTITUTIONAL AND STATUTORY PRO-<br>VISIONS INVOLVED .....  | 1    |
| INTRODUCTION .....   | 2    |
| STATEMENT OF THE CASE.....   | 4    |
| A. Statutory Background .....  | 4    |
| B. Factual Background.....   | 6    |
| C. Proceedings Below .....   | 8    |
| REASONS FOR GRANTING THE PETITION...   | 11   |
| I. THE DECISION BELOW CONFLICTS<br>WITH THIS COURT'S PRECEDENTS .....  | 13   |
| A. The Decision Below Conflicts With This<br>Court's Decisions Holding That A State<br>May Not Discriminate Against Inter-<br>state Commerce.....            | 13   |
| B. The Decision Below Conflicts With This<br>Court's Decisions Holding That A State<br>Must Fairly Apportion Taxes On Inter-<br>state Activity .....         | 20   |
| II. REVIEW IS WARRANTED BECAUSE<br>THIS CASE SQUARELY PRESENTS<br>ISSUES OF SURPASSING IMPORTANCE<br>TO TAXPAYERS AND STATES<br>THROUGHOUT THE COUNTRY ..... | 25   |

## TABLE OF CONTENTS – continued

|  | Page |
|--|------|
| CONCLUSION .....   | 31   |
| APPENDIX A: <i>Ex Parte VFJ Ventures, Inc.</i><br>( <i>Surtees v. VFJ Ventures, Inc.</i> ), No. 1070718<br>(Ala. Sept. 19, 2008) ..... | 1a   |
| APPENDIX B: <i>Surtees v. VFJ Ventures, Inc.</i> ,<br>No. 2060478 (Ala. Civ. App. Feb. 8, 2008) .....                                  | 4a   |
| APPENDIX C: <i>VFJ Ventures, Inc. v. Surtees</i> ,<br>No. CV-03-3172 (Cir. Ct. Montgomery<br>County, Ala. Jan. 24, 2007) .....         | 65a  |
| APPENDIX D: State Statutes .....   | 78a  |

## TABLE OF AUTHORITIES

| CASES   | Page               |
|---|--------------------|
| <i>Camps Newfound/Owatonna, Inc. v. Town of Harrison</i> , 520 U.S. 564 (1997) ..   | 12, 15, 18, 26     |
| <i>Complete Auto. Transit, Inc. v. Brady</i> , 430 U.S. 274 (1977) .....  | 2, 13, 16          |
| <i>Container Corp. of Am. v. Franchise Tax Bd.</i> , 463 U.S. 159 (1983) .....  | 30, 20, 24         |
| <i>Deluxe Fin. Servs., Inc. v. Director, Div. of Taxation</i> , No. 005522-2006 (N.J.T.C. filed May 30, 2006) .....                       | 30                 |
| <i>Family Dollar Stores of Ohio, Inc. v. Wilkins</i> , No. 2005-V-469, 2008 Ohio Tax LEXIS 5 (Ohio Bd. of Tax Appeals Jan. 4, 2008) ..... | 30                 |
| <i>Fulton Corp. v. Faulkner</i> , 516 U.S. 325 (1996) .....   | <i>passim</i>      |
| <i>Granholm v. Heald</i> , 544 U.S. 460 (2005) .....  | 18                 |
| <i>Healy v. Beer Inst., Inc.</i> , 491 U.S. 324 (1989) .....  | 13, 18, 19, 26, 27 |
| <i>Hunt v. Washington State Apple Adver. Comm'n</i> , 432 U.S. 333 (1977) .....   | 19                 |
| <i>Hunt-Wesson, Inc. v. Franchise Tax Bd.</i> , 528 U.S. 458 (2000) .....   | <i>passim</i>      |
| <i>McKesson Corp. v. Division of Alcoholic Beverages &amp; Tobacco</i> , 496 U.S. 18 (1990) .....   | 4, 13, 29, 30      |
| <i>Moorman Mfg. Co. v. Bair</i> , 437 U.S. 267 (1978) .....   | 24                 |
| <i>New Energy Co. of Ind. v. Limbach</i> , 486 U.S. 269 (1988) .....  | 3, 12, 17, 18, 26  |
| <i>Nixon v. Shrink Mo. Gov't PAC</i> , 528 U.S. 377 (2000) .....  | 3                  |
| <i>Norfolk &amp; W. Ry. v. Missouri State Tax Comm'n</i> , 390 U.S. 317 (1968) .....  | 20, 23             |

## TABLE OF AUTHORITIES – continued

|  | Page       |
|--|------------|
| <i>Oklahoma Tax Comm'n v. Jefferson Lines, Inc.</i> , 514 U.S. 175 (1995).....               | 20, 24, 25 |
| <i>Oregon Waste Sys., Inc. v. Department of Env'tl. Quality</i> , 511 U.S. 93 (1994) ....    | 13, 15, 17 |
| <i>Polar Tankers, Inc. v. City of Valdez</i> , No. 08-310 (cert. granted Dec. 12, 2008)..... | 27         |
| <i>Quill Corp. v. North Dakota ex rel. Heitkamp</i> , 504 U.S. 298 (1992).....               | 18         |
| <i>South Cent. Bell Tel. Co. v. Alabama</i> , 526 U.S. 160 (1999).....                       | 15, 27     |
| <i>Tully v. Griffin, Inc.</i> , 429 U.S. 68 (1976) .....                                     | 30         |
| <i>Virginia Dep't of Taxation</i> , P.D. 07-153, 2007 Va. Tax LEXIS 155 (Oct. 2, 2007) ....  | 30         |
| <i>West Lynn Creamery, Inc. v. Healy</i> , 512 U.S. 186 (1994).....                          | 15, 16, 26 |

## CONSTITUTION, STATUTES AND REGULATION

|   |                |
|---|----------------|
| U.S. Const. art. I, § 8, cl.3 .....         | 1              |
| amend. XIV .....                            | 2              |
| Ala. Laws 2008-543 .....                    | 6              |
| Ala. Code § 40-2A-9(g)(b) .....             | 30             |
| § 40-18-1(28)-(29).....                     | 5              |
| § 40-18-2(a) .....                          | 4              |
| § 40-18-31.....                             | 4              |
| § 40-18-33.....                             | 4              |
| § 40-18-34.....                             | 4              |
| § 40-18-35(b) .....                         | 2, 4, 5, 6, 16 |
| § 40-27-1 .....                             | 4, 6, 16       |
| Ark. Code Ann. 26-51-423(g)(1) .....        | 27             |
| Conn. Gen. Stat. § 12-218(c) .....          | 28             |
| D.C. Code § 47-1803.03(a)(19)(B) .....      | 28             |
| Ga. Code Ann. § 48-7-28.3(d)(2).....        | 27             |
| 35 Ill. Comp. Stat. 5/203(a)(2)(D-18) ..... | 27             |
| Ind. Code § 6-3-2-20(c)(2) .....            | 27             |

## TABLE OF AUTHORITIES – continued

|   | Page |
|---|------|
| Ky. Rev. Stat. Ann. § 141.205(3)(b) .....   | 27   |
| Md. Code Ann., Tax-Gen. § 10-306.1(c) ..... | 28   |
| Mass. Gen. Laws ch. 63, § 31I .....         | 28   |
| Mich. Comp. Laws § 208.1201(2)(f)(ii) ..... | 27   |
| N.C. Gen. Stat. 105-130.7A .....            | 28   |
| N.J. Stat. Ann. § 54:10A-4.4 .....          | 28   |
| Ohio Rev. Code Ann. § 5733.042 .....        | 27   |
| § 5733.055(A)(2) .....                      | 27   |
| R.I. Gen. Laws § 44-11-11(f)(3) .....       | 28   |
| Va. Code Ann. § 58.1-402(B)(8)(a)(1) .....  | 27   |
| 830 Mass. Code Regs. 63.31.1 .....          | 28   |
| N.J. Admin. Code § 18:7-5.18(b)(3) .....    | 28   |

## RULE

|                         |    |
|-------------------------|----|
| Sup. Ct. R. 10(c) ..... | 25 |
|-------------------------|----|

## SCHOLARLY AUTHORITIES

|  |        |
|--|--------|
| Charles F. Barnwell, <i>Addback: It's Payback Time</i> , 50 State Tax Notes 437 (Nov. 17, 2008) .....  | 28     |
| Donald M. Griswold, <i>Addbacks Add Nothing to the Debate</i> , 48 State Tax Notes 1073 (June 30, 2008) .....  | 28     |
| 1 Jerome R. Hellerstein & Walter Hellerstein, <i>State Taxation</i> (3d ed. 2008) .....  | 23, 30 |
| Walter Hellerstein & John Swain, <i>Further Thoughts on the 'Subject to Tax' Exception in State Corporate Income Tax Expense Disallowance Statutes</i> , 48 State Tax Notes 597 (May 19, 2008) ..... | 29     |
| Sarah McGahan, <i>The 'Unreasonable' Exception to Addback</i> , [19-Aug] J. of Multistate Tax'n & Incentives 6 (2008) ....   | 29     |

## TABLE OF AUTHORITIES – continued

|   | Page |
|---|------|
| Thomas H. Steele & Pilar M. Sansone,<br><i>Surveying Constitutional Theories for<br/>Challenges to the Addback Statutes</i> 35<br>State Tax Notes 613 (Feb. 28, 2005) ..... | 28   |
| Thomas H. Steele & Pilar M. Sansone,<br><i>Alabama's Addback Case: The Trial<br/>Court Got It Right</i> , 48 State Tax Notes<br>593 (May 19, 2008).....                     | 29   |
| Giles Sutton & Todd Zoellick, <i>The Ins and<br/>Outs of Related Party Add-Backs</i> , Tax<br>Executive 139 (May-June 2005) .....   | 28   |

## OTHER AUTHORITIES

|   |    |
|---|----|
| John C. Healy & Michael Schadewald,<br><i>Multistate Corporate Tax Guide</i> (2008).....  | 27 |
| Multistate Tax Comm'n, <i>Model Statute<br/>Requiring the Add-back of Certain<br/>Intangible &amp; Interest Expenses</i> (Aug. 17,<br>2006), <a href="http://www.mtc.gov/Uniformity.aspx?id=500&amp;ItemId=500">http://www.mtc.gov/Uniformity.<br/>aspx?id=500&amp;ItemId=500</a> ..... | 29 |
| Robert L. Stern et al., <i>Supreme Court<br/>Practice</i> (8th ed. 2002) .....  | 28 |

## **PETITION FOR A WRIT OF CERTIORARI**

Petitioner VFJ Ventures, Inc. ("VFJ") respectfully requests that this Court grant the petition for a writ of certiorari to review the decision and judgment of the Supreme Court of Alabama.

## **OPINIONS BELOW**

The opinion of the Supreme Court of Alabama is not yet reported, but is available at 2008 Ala. LEXIS 197, and is reproduced in the Appendix to this Petition ("Pet. App.") at 1a-3a. The opinion of the Alabama Court of Civil Appeals is not yet reported, but is available at 2008 Ala. Civ. App. LEXIS 50 and reproduced at Pet. App. 4a-64a. The opinion of the Circuit Court of Montgomery County, Alabama, is unreported and is reproduced at Pet. App. 65a-77a.

## **JURISDICTION**

The judgment of the Supreme Court of Alabama was entered on September 19, 2008. On December 2, 2008, Justice Thomas extended the time to file a petition for a writ of certiorari to January 20, 2009. This Court was closed on January 20, 2009. See Sup. Ct. R. 30.1. This Court has jurisdiction under 28 U.S.C. § 1257(a).

## **CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED**

The Commerce Clause of the United States Constitution, art. I, § 8, cl. 3, provides: "The Congress shall have Power . . . [t]o regulate Commerce . . . among the several States . . . ."

The Due Process Clause of the Fourteenth Amendment to the United States Constitution, § 1,

provides: “[N]or shall any State deprive any person of life, liberty, or property, without due process of law . . . .”

Alabama Code Sections 40-18-33 and 40-18-35(b) are reproduced at Pet. App. 78a-80a.

## INTRODUCTION

This case concerns the State of Alabama’s discriminatory treatment of ordinary business expenses in the form of royalties paid by petitioner VFJ to two related Delaware corporations, The H.D. Lee Company, Inc. (“Lee”) and Wrangler Apparel Corp., as successor to Wrangler Clothing Corp. (“Wrangler”). Because Lee and Wrangler are located in Delaware (a State that has chosen not to tax these royalty payments), Alabama law requires VFJ to “add back” those payments, which otherwise would have been deductible from its Alabama income, when calculating its Alabama income tax obligation. Ala. Code § 40-18-35(b). In the decision below, the Alabama Supreme Court rejected VFJ’s constitutional challenges to Alabama’s taxing scheme. Pet. App. 2a. That ruling warrants this Court’s review.

First, the decision of the Alabama Supreme Court conflicts with decisions of this Court holding that a State may not adopt a tax system that “taxes a transaction or incident more heavily when it crosses state lines.” *Fulton Corp. v. Faulkner*, 516 U.S. 325, 331 (1996) (internal quotation marks and alteration omitted); see *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). The discrimination in Alabama’s add-back statute is manifest. If Lee and Wrangler were located in Alabama (or another State that shares Alabama’s policy of taxing royalty payments), then VFJ could have deducted its royalty payments from its Alabama income for the tax year

at issue. See *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 274-75 (1988). Because Lee and Wrangler are located in Delaware, however, Alabama required VFJ to “add back” those payments to its taxable Alabama income and to pay an additional \$1 million in Alabama income taxes.

Second, the decision of the Alabama Supreme Court conflicts with this Court’s decisions holding that the Commerce and Due Process Clauses require States to apportion fairly income from interstate transactions. See, e.g., *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000); see also *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983) (Due Process and Commerce Clauses prevent a State from taxing “value earned outside its borders”). Fair apportionment requires that a state taxing statute must “actually reflect a reasonable sense of how income is generated.” *Hunt-Wesson*, 528 U.S. at 466 (quoting *Container Corp.*, 463 U.S. at 169). Here, Alabama law violates the Constitution because it attributes income to Alabama based not upon VFJ’s conduct in Alabama, but instead upon the tax policy of the State (Delaware) in which Lee and Wrangler are located.

Finally, there is a pressing need to address the conflict between the decision below and this Court’s cases. The need for prompt review is especially important because add-back statutes like the one enacted by Alabama have been adopted by 19 other States and have been advocated for adoption in others. See *Nixon v. Shrink Mo. Gov’t PAC*, 528 U.S. 377, 385 (2000) (granting review to assess conflict between state political contribution statute and prior Court precedent given the “large number of States that limit political contributions”). Moreover, a determination of the constitutionality of the Alabama add-

back statute is critically important both for the taxpayers subjected to such provisions and to the States that would be required to remedy any unconstitutional deprivation. See, e.g., *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 31 (1990). Taxpayers and States from across the Nation thus would benefit from this Court's immediate review of the decision below.

The petition for writ of certiorari should be granted.

## STATEMENT OF THE CASE

### A. Statutory Background

The State of Alabama imposes an income tax on corporations that do business or derive income from sources within Alabama. Ala. Code §§ 40-18-2(a), -31. Under Alabama law, the starting point for determining a corporation's Alabama taxable income is the corporation's federal taxable income. *Id.* § 40-18-33. Alabama law requires a corporation to make adjustments to its federal taxable income and to determine the amount "allocated and apportioned to Alabama." *Id.* §§ 40-18-33, -34.<sup>1</sup>

In 2001, Alabama altered its method for calculating a corporation's Alabama taxable income by enacting the "add-back" statute at issue in this case. Ala. Code § 40-18-35(b); Pet. App. 12a. Section 40-18-35(b) sets forth "[r]estrictions on the deductibility of certain intangible expenses and interest expenses with a

---

<sup>1</sup> Alabama uses an apportionment formula that considers what fraction of the taxpayer's payroll, property, and sales are located in-state. Pet. App. 6a-7a; see Ala. Code § 40-27-1, art. IV, ¶ 9. The formula yields a percentage, known as the taxpayer's "Alabama apportionment factor," that is applied to the taxpayer's apportionable income to determine its Alabama taxable income. Pet. App. 6a-7a.

related member.” Ala. Code § 40-18-35(b). As relevant here, the add-back statute provides: “For purposes of computing its taxable income, a corporation shall add back otherwise deductible . . . intangible expenses and costs directly or indirectly paid . . . to . . . one or more related members, except to the extent the corporation shows . . . that the corresponding item of income was in the same taxable year: a. *Subject to a tax based on or measured by the related member’s net income in Alabama or any other state of the United States . . .*” *Id.* § 40-18-35(b)(1) (emphasis added).<sup>2</sup> The add-back statute further provides: “For purposes of this section, ‘subject to a tax based on or measured by the related member’s net income’ means that the receipt of the payment by the recipient related member is reported and included in income for purposes of a tax on net income” of the related member. *Id.*<sup>3</sup>

---

<sup>2</sup> A “related member” is defined to include entities in a commonly owned corporate group that includes the taxpayer. Ala. Code § 40-18-1(28)-(29).

<sup>3</sup> As relevant here, the add-back statute provides two additional exceptions to the “add-back” requirement: (i) where the “corporation establishes that the adjustments are unreasonable, or the corporation and the Commissioner of Revenue agree in writing to the application,” or (ii) “if the corporation can establish that” [1] “the transaction giving rise to the interest expenses and costs or the intangible expenses and costs between the corporation and the related member did not have as a principal purpose the avoidance of any Alabama tax” and [2] “the related member is not primarily engaged in the acquisition, use, licensing, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property, or in the financing of related entities.” Ala. Code § 40-18-35(b)(2)-(3). In 2008, Alabama amended its add-back statute to codify the Alabama Supreme Court’s conclusion that the subject-to-tax exception applied only on a post-apportionment basis and to provide an additional exception when the related

Alabama taxes income from royalty payments for intangible assets. See Ala. Code § 40-27-1, art. IV ¶ 1(a). Thus, under the add-back statute, if a corporation in Alabama makes a royalty payment to a related corporation located in Alabama (or another State that shares Alabama's policy of taxing royalty payments), then that payment remains deductible from Alabama income. *Id.* § 40-18-35(b). If, however, that same Alabama taxpayer instead makes its royalty payments to a related corporation located in a State that, unlike Alabama, has chosen not to tax royalty payments (such as Delaware, Nevada, Wyoming, or South Dakota), then it is denied the deduction for this ordinary business expense.

## **B. Factual Background**

Petitioner VFJ is a corporation headquartered in North Carolina that manufactures and sells Lee and Wrangler jeanswear throughout the United States. During the tax year at issue, VFJ operated a cutting facility and two distribution facilities in Alabama, and therefore filed an Alabama income tax return. Pet. App. 5a. The trademarks for Lee and Wrangler are owned by The H.D. Lee Company, Inc. ("Lee") and Wrangler Apparel Corp., as successor to Wrangler Clothing Corp. ("Wrangler"). *Id.* at 8a. Lee and Wrangler are Delaware corporations that do not file income tax returns in Alabama. Although VFJ, Lee, and Wrangler are separate companies, they are "related members" within the meaning of Alabama law because they are affiliated subsidiaries of V.F. Corporation. *Id.* at 66a-67a.

---

member pays the royalty income to an unrelated third party. See Ala. Laws 2008-543, § 1. Those amendments have no bearing on the constitutional issues raised in this petition.

Lee and Wrangler license their respective trademarks in arm's-length agreements with both unrelated third parties and related companies like VFJ. Pet. App. 8a. For example, in 2001, 22% of Lee's royalty income was derived from payments by unrelated third parties. *Id.* at 69a. Notably, Lee and Wrangler charge VFJ the same 5% royalty rate that they typically charge to unrelated third-parties. *Id.* at 8a-9a; Trial Tr. 196-97.

In the past, responsibility for managing Lee's and Wrangler's trademarks was dispersed among different divisions of various V.F.-related manufacturing companies around the world. Pet. App. 17a, 67a-68a. The fragmented nature of this trademark management prevented the development of trademark expertise or coordination of licensing efforts. *Id.* V.F. Corporation isolated the Lee trademarks in a separate corporation in 1983, and did the same with the Wrangler trademarks in 1993. Trial Tr. 238. As a result, a staff of trademark specialists in Delaware now coordinates trademark registrations around the world, negotiates and monitors licensing agreements, and guards the trademarks against infringement. Pet. App. 17a-21a. The Lee and Wrangler trademark portfolios have been valued at about \$5 billion. *Id.* at 66a-67a.

In 2001, VFJ paid royalties of \$36.22 million and \$66.42 million to Lee and Wrangler, respectively, to use their trademarks. Pet. App. 9a. VFJ deducted those royalty payments as ordinary and necessary business expenses on its 2001 federal income tax return. *Id.* Those deductions flowed through to VFJ's Alabama apportionable income and reduced its taxable income. *Id.* at 9a-10a. VFJ's apportionment factor for Alabama in 2001 was approximately 13.9%. *Id.* at 7a. Applying that factor to VFJ's apportionable

income yielded \$13,702,000 in Alabama taxable income. *Id.* VFJ paid Alabama tax on that amount.

The Alabama Department of Revenue ("the Department") audited VFJ's 2001 return and concluded that Alabama's add-back statute required VFJ to add back a portion of the deductions taken for royalty payments to Lee and Wrangler. Pet. App. 15a. In 2001, Lee and Wrangler paid income tax on a portion of their royalty income in North Carolina, the home State of V.F. Corporation. *Id.* at 72a. The Department concluded that the North Carolina portions of the royalty payments were subject to tax in North Carolina within the meaning of the add-back statute, and therefore exempted the North Carolina portions of the royalty payments from the add-back requirement. *Id.* at 42a-44a. The Department, however, required VFJ to add back the remainder of the royalty payments and assessed tax on that amount of additional income. *Id.* The Department issued an additional assessment of \$1.02 million. *Id.* at 15a.

### C. Proceedings Below

1. VFJ sought relief from the \$1.02 million assessment in the Circuit Court of Montgomery County, Alabama. It challenged the application of Alabama's add-back statute on both statutory and federal constitutional grounds. Pet. App. 65a-66a. The circuit court conducted a multi-day trial at which it "had the benefit of hearing from the premier experts in the fields of taxation and patents and trademarks." *Id.* at 66a.

The circuit court found that that Lee and Wrangler "carry on substantial activities" in Delaware, Pet. App. 69a, and that while "[c]entralization of trademarks" in Lee and Wrangler "had beneficial state tax

effects for the VF group," it also "increased efficiency by concentrating management in one group of employees instead of being spread throughout the various operating subsidiaries around the world." *Id.* at 67a.<sup>4</sup> The circuit court found that these Delaware entities "monitor and maintain thousands of trademark registrations throughout the world," *id.* at 69a, and "license trademarks to VF affiliates" as well as "numerous third parties." *Id.*

Based on this factual record, the circuit court held that, as a matter of Alabama statutory law, application of the add-back statute was unwarranted because VFJ had satisfied a statutory exception to the add-back requirement by showing that adding back these royalty payments to its income would be "unreasonable." Specifically, the circuit court concluded that add-back of the royalty payments was "unreasonable" because "VFJ's royalty payments are not abusive – they have economic substance and business purpose – and represent real and necessary costs of doing business in Alabama." Pet. App. 75a. As a result, the circuit court concluded that "to disallow these deductions would distort the amount of VFJ's income fairly attributable to this state." *Id.* Because it resolved VFJ's challenge on statutory grounds, the circuit court did not address the parties' arguments regarding "the constitutionality of the add-back statute." *Id.* at 77a.

---

<sup>4</sup> For example, the trial court found that centralization of trademarks in Lee and Wrangler (i) "allowed the employees to develop the expertise necessary to maintain the necessary registrations and monitor and combat infringement worldwide," (ii) "reduced duplicative efforts, costs, and reliance on outside counsel," and (iii) "allowed third party licensing efforts to be coordinated and managed." Pet. App. 67a-68a.

2. On appeal, the Alabama Court of Civil Appeals reversed. It rejected the circuit court's conclusion that the Alabama legislature adopted the "add-back statute to address the problem of sham transactions" or "to create a new method by which it could challenge sham transactions." Pet. App. 36a. Rather, the court of appeals concluded that the legislature intended "to eliminate, subject to certain exceptions, one type of deduction for ordinary and necessary business [expenses]." *Id.* at 37a. The court adopted the Department's construction of the add-back statute, ruling that the "unreasonableness exception" did not apply because there had been no showing that "the add-back statute results in taxation that is out of proportion to [VFJ's] activities in Alabama." *Id.* at 39a.

Having rejected VFJ's statutory challenge to the application of the add-back requirement, the court of appeals turned to VFJ's federal constitutional challenges. The court of appeals rejected VFJ's showing that the add-back statute was discriminatory. The court stated that the subject-to-tax exception "applies when the related member's income is taxed 'in Alabama or any other State of the United States'" and thus the exception "is implicated regardless of which state imposes a tax on the related member's income." Pet. App. 62a. The court held that the add-back statute does not "discriminate against interstate commerce" because "the language of the subject-to-tax exception clearly indicates that, with regard to that exception, the application of Alabama's add-back statute does not benefit in-state corporations to the detriment of, or disproportionately to, out-of-state corporations." *Id.*

Likewise, the court of appeals rejected VFJ's showing that the "add-back statute results in a tax

that is not fairly apportioned to Alabama.” Pet. App. 56a. The court of appeals did not expressly address VFJ’s showing that, under the add-back statute, the determination whether VFJ is taxed on its royalty payment to Lee and Wrangler turns on an analysis of the tax policy of the State of Delaware. *Id.* at 58a-61a. Instead, the court concluded that “the evidence did not demonstrate that the application of the add-back statute has resulted in taxation that is out of proportion to VFJ’s activities in this State [Alabama].” *Id.* at 60a. As such, the court held that that “VFJ has not demonstrated that the add-back statute results in taxation of income that is not fairly attributable to Alabama.” *Id.* at 61a.

3. VFJ appealed to the Alabama Supreme Court. VFJ again demonstrated that the add-back statute violated the United States Constitution because it was discriminatory and did not fairly apportion VFJ’s income. Opening Brief 25-35; Reply Brief 6-19. The Alabama Supreme Court rejected VFJ’s constitutional challenges, affirmed the judgment of the court of appeals, and adopted the court of appeals’ “opinion in its entirety, as the opinion of this Court.” Pet. App. 2a.

### REASONS FOR GRANTING THE PETITION

This Court should grant review because the decision of the Alabama Supreme Court squarely conflicts with this Court’s decisions holding that State tax statutes may not discriminate against interstate commerce. See, e.g., *Fulton*, 516 U.S. at 331. The Alabama add-back statute prevents VFJ from deducting multi-million dollar arm’s-length royalty payments to Lee and Wrangler solely because Lee and Wrangler are located outside Alabama in a State (Delaware) that does not share Alabama’s

policy of taxing these payments. The Commerce Clause prohibits Alabama from discriminating against interstate commerce or conditioning favored treatment on another State's adoption of Alabama's taxing policy. The decision below, which approves of that discrimination, directly conflicts with this Court's Commerce Clause decisions. See, e.g., *New Energy*, 486 U.S. at 274-75.

Similarly, review should be granted because the Alabama Supreme Court's decision conflicts with this Court's decisions holding a State must "fairly apportion" income from interstate transactions. See, e.g., *Hunt-Wesson*, 528 U.S. at 467-68. Alabama's add-back statute violates that requirement because it does not attribute royalty income to VFJ based on "a reasonable sense of how income is generated." *Id.* at 466 (quoting *Container Corp.*, 463 U.S. at 169). Rather, the apportionment to Alabama is based on an assessment of the tax policy of a sister State without regard to VFJ's economic activity in Alabama.

There is a pressing need to address the conflicts implicated by the decision below. This Court has underscored the importance of reviewing claims of discrimination by States against interstate commerce even when the offending statute was limited in its scope and unique to a single State. E.g., *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 595 (1997). Here, the need for immediate review is far more pronounced because the Alabama add-back statute has a broad sweep within Alabama and, further, because similar discriminatory statutes have been adopted by nearly 20 States (and have been advocated for adoption in others). Prompt determination of the constitutionality of the add-back statute is critically important both for the taxpayers who are presently subjected to such provisions and to

the States that would be required to remedy any unconstitutional deprivation and address any budgetary shortfalls resulting from an adverse decision. See, e.g., *McKesson*, 496 U.S. at 31. In short, the sooner the constitutionality of these add-back statutes is resolved, the better – for all involved.

The petition for writ of certiorari should be granted.

## **I. THE DECISION BELOW CONFLICTS WITH THIS COURT'S PRECEDENTS.**

Under the Due Process and Commerce Clauses, a state tax must “not discriminate against interstate commerce” and must be “fairly apportioned.” *Complete Auto*, 430 U.S. at 279. Review is warranted in this case because Alabama’s “add-back” statute violates both of these bedrock constitutional requirements.

### **A. The Decision Below Conflicts With This Court’s Decisions Holding That A State May Not Discriminate Against Interstate Commerce.**

1. This Court has long confirmed that the Commerce Clause’s grant of regulatory power to Congress has “a ‘negative’ aspect that denies the States the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce.” *Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 511 U.S. 93, 98 (1994) (citing cases). That negative aspect “reflect[s] the Constitution’s special concern both with the maintenance of a national economic union unfettered by state-imposed limitations on interstate commerce and with the autonomy of the individual States within their respective spheres.” *Healy v. Beer Inst., Inc.*, 491 U.S. 324, 335-36 (1989) (footnote omitted). In the tax arena, a state statute impermissibly discriminates against inter-

state commerce "if it taxes a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." *Fulton Corp.*, 516 U.S. at 331 (internal quotation marks and alteration omitted).

This Court's decision in *Fulton* is instructive. At issue in *Fulton* was North Carolina's "intangibles tax" on the fair market value of corporate stock held by North Carolina residents. *Id.* at 327-28. The North Carolina tax did not apply evenly to all stock holdings, but instead allowed residents to deduct the value of a stock to the extent that the issuing corporation was subject to tax in North Carolina. *Id.* at 328. Thus, a multi-state corporation doing five percent of its business in North Carolina would pay corporate income tax on 5% of its income, and a resident owner of that corporation's stock would pay tax on 95% of the stock's value. *Id.* By contrast, a corporation doing all of its business in North Carolina would pay corporate income tax on 100% of its income, and a resident owner of that corporation's stock would pay no tax on the stock's value.

This Court had "no doubt" that the North Carolina tax discriminated against interstate commerce because it taxed stock "only to the degree that its issuing corporation participated in interstate commerce," and "favor[ed] domestic corporations over their foreign competitors in raising capital among North Carolina residents." *Id.* at 333. As a result, the tax tended to "discourage domestic corporations from plying their trades in interstate commerce." *Id.*

2. Like the discriminatory tax invalidated in *Fulton*, the Alabama add-back statute imposes a differential burden on an Alabama taxpayer based upon the interstate nature of its ordinary and necessary business expenses. If Lee and Wrangler

were located in Alabama, VFJ could have deducted the royalty payments it made to them when calculating its Alabama tax liability. However, because Lee and Wrangler are located in Delaware – a State that does not share Alabama's policy of taxing royalty income – VFJ is denied a deduction for what no one disputes are ordinary and necessary business expenses. The add-back statute thus subjects VFJ's interstate payments to Lee and Wrangler to disfavored treatment resulting in an increased tax burden of over \$1 million solely because Lee and Wrangler are located in Delaware, rather than in Alabama.

Accordingly, there can be no question that Alabama's add-back statute discriminates against interstate commerce in a manner prohibited by the Commerce Clause. See *Oregon Waste*, 511 U.S. at 99 (“discrimination” “means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter”). The decision below sustaining Alabama's add-back tax thus conflicts with the long line of cases invalidating discriminatory statutes that tax a transaction more heavily when it crosses state lines. See, e.g., *South Cent. Bell Tel. Co. v. Alabama*, 526 U.S. 160, 169 (1999) (following *Fulton*); *Camps Newfound*, 520 U.S. at 580-81 (same).

As this Court explained in *West Lynn Creamery v. Healy*: “For over 150 years, our cases have rightly concluded that the imposition of a differential burden on any part of the stream of commerce . . . is invalid, because a burden placed at any point will result in a disadvantage to the out-of-state producer.” 512 U.S. 186, 202 (1994). Here, the Alabama add-back statute violates the Commerce Clause because it imposes a “differential burden” on transactions with corpora-

tions located outside Alabama in States that do not share Alabama's policy of taxing royalty payments.

3. To avoid this clear precedent, the Alabama Supreme Court adopted the view that the add-back statute did not discriminate against interstate commerce at all. According to that court, there is no discrimination because transactions involving corporations located in other States also are eligible for preferential treatment if they embrace fully Alabama's policy of taxing royalty payments to corporations. Pet. App. 62a. Specifically, the court below stated that the subject-to-taxation exception "applies when the related member's income is taxed 'in Alabama or any other State of the United States,'" and thus ruled that there is no discrimination because that exception "is implicated regardless of which state imposes a tax on the related member's income." *Id.*

That conclusion is wrong because it utterly ignores the discriminatory operation of Alabama's add-back regime. See *Complete Auto*, 430 U.S. at 279; *West Lynn Creamery*, 512 U.S. at 201 ("The commerce clause forbids discrimination, whether forthright or ingenious."). The add-back statute is part of the Alabama tax code, which explicitly taxes royalty income. See Ala. Code § 40-27-1, art. IV ¶ 1(a). The add-back statute's "subject-to-tax exception" is expressly limited to States like Alabama, which *subject such payments to tax*. *Id.* § 40-18-35(b)(1). Thus, on its face, the add-back statute allows a deduction for royalty payments made to companies in Alabama (and States that share Alabama's tax policy), but disallows the deduction for royalty payments made to States outside Alabama that choose a different tax policy. The impact of Alabama's add-back statute is the same as a statute

that, in so many words, gave a deduction for payments to companies in taxing States, but denied the deduction for payments made to companies in States such as Delaware, which do not tax the payments. Accordingly, the add-back regime is "virtually *per se* invalid." *Oregon Waste*, 511 U.S. at 99.

To be sure, the Alabama add-back statute does not discriminate against *all* interstate transactions. But this Court has made clear that discrimination against transactions involving some, rather than all, States likewise violates the Commerce Clause. Thus, in *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269 (1988), this Court struck down an Ohio statute that denied a tax benefit for ethanol produced in States outside Ohio *unless* those States adopted Ohio's policy of granting tax benefits to Ohio ethanol producers. *Id.* at 274. This Court rejected the claim that "the Ohio provision, far from discriminating against interstate commerce, is likely to promote it, by encouraging other States to enact similar tax advantages that will spur the interstate sale of ethanol." *Id.* Instead, this Court held that the Ohio statute was invalid because (i) it "impose[d] an economic disadvantage upon out-of-state sellers" and (ii) "the promise to remove that [disadvantage] if reciprocity is accepted no more justifies disparity of treatment than it would justify categorical exclusion." *Id.* at 275.

Here, the Alabama add-back statute discriminates against interstate commerce because it imposes a differential burden on the royalty payments paid by VFJ solely because Lee and Wrangler are located in Delaware, rather than in Alabama or another State that shares Alabama's policy of taxing such payments. The Alabama add-back statute disrupts

interstate commerce by allowing a licensee to deduct royalty payments made to a licensor in Alabama (a taxing state), but requiring a licensee to add back those same payments when made to a licensor located in a non-taxing state. As in *New Energy*, Alabama's add-back statute imposes a discriminatory "economic disadvantage upon out-of-state" licensors that cannot be justified by Alabama's offer to remove that burden if the sister State in which Lee and Wrangler are located abandons its own tax policy in favor of Alabama's. See *id.*

Alabama may not "project[]" its taxing policy "into other States" by disfavoring transactions by corporations in Alabama with entities located in other States that do not share its policy of taxing royalty income. *Healy*, 491 U.S. at 334 (internal quotation marks and alteration omitted). Here, the Alabama add-back statute discriminates among States according to whether they tax royalty income, *i.e.*, whether they share Alabama's own tax policy. Alabama's approach classically "Balkaniz[es]" the Nation's economy by setting its tax policy to have different effects on interstate commerce in some States, but not others. *Camps Newfound*, 520 U.S. at 577 (quoting *Hughes v. Oklahoma*, 441 U.S. 322, 325 (1979)); see *Quill Corp. v. North Dakota ex rel. Heitkamp*, 504 U.S. 298, 312 (1992) ("Under the Articles of Confederation, state taxes and duties hindered and suppressed interstate commerce; the Framers intended the Commerce Clause as a cure for these structural ills."). Indeed, it is these potential "[r]ivalries among States" that the Commerce Clause was intended to "ke[ep] to a minimum." *Granholm v. Heald*, 544 U.S. 460, 472 (2005).

4. Finally, the Alabama Supreme Court also contended that the add-back statute was not

discriminatory because, in its view, the statute “does not benefit in-state corporations to the detriment of, or disproportionately to, out-of-state corporations.” Pet. App. 62a. That is plainly wrong. Just as the North Carolina statute at issue in *Fulton* “favor[ed] domestic corporations over their foreign competitors in raising capital among North Carolina residents,” 516 U.S. at 333, the Alabama add-back statute favors domestic corporations over their out-of-state competitors by making payments to the former deductible to corporations located in Alabama.

Like the North Carolina statute in *Fulton*, which tended to “discourage domestic corporations from plying their trades in interstate commerce,” *id.*, the Alabama add-back statute discourages Alabama corporations from entering into royalty agreements with related members located in certain other States or from setting up related members in non-taxing States. Indeed, the Alabama add-back statute impermissibly “has the effect of stripping away . . . the competitive and economic advantages” that Lee and Wrangler offer by virtue of their location in a State – Delaware – that has chosen a more favorable tax policy. *Hunt v. Washington State Apple Advert. Comm’n*, 432 U.S. 333, 351 (1977). The add-back statute thus violates the Commerce Clause’s core aim of preventing States from “depriv[ing] businesses and consumers in other States of whatever competitive advantages they may possess based on the conditions of the local market.” *Healy*, 491 U.S. at 339 (internal quotation marks omitted); see *Fulton*, 516 U.S. at 333 n.3 (Commerce Clause seeks to prevent States from “promot[ing] . . . in-state markets at the expense of out-of-state ones”).

**B. The Decision Below Conflicts With This Court's Decisions Holding That A State Must Fairly Apportion Taxes On Interstate Activity.**

Review by this Court is independently warranted because the decision below conflicts with this Court's decisions requiring that a taxing State fairly apportion income by adopting a system that "actually reflect[s] a reasonable sense of how income is generated." *Hunt-Wesson*, 528 U.S. at 466 (quoting *Container Corp.*, 63 U.S. at 169). Under the add-back statute, the determination whether to tax VFJ's royalty payment turns not on VFJ's conduct in Alabama, but on the tax policy of the State (Delaware) in which Lee and Wrangler are located.

1. The Commerce and Due Process Clauses permit a State to tax only its fair share of the income generated by a corporation operating in multiple States. See *Container Corp.*, 463 U.S. at 164. A State's method of apportioning income must ensure both "internal consistency" and "external consistency." *Id.* at 169; see *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995). As relevant here, "external consistency" requires that the State's apportionment method "actually reflect[s] a reasonable sense of how income is generated." *Container Corp.*, 463 U.S. at 169. Specifically, external consistency demands that an apportionment formula "bear a rational relationship, both on its face and in its application, to [the taxpayer's activities] connected with the taxing State." *Norfolk & W. Ry. v. Missouri State Tax Comm'n*, 390 U.S. 317, 325 (1968).

For example, in *Hunt-Wesson*, this Court analyzed a California statute that dictated how a corporation must allocate an interest-expense deduction between

unitary income (which California could constitutionally tax) and nonunitary income (which California could not tax).<sup>5</sup> 528 U.S. at 460-61. The California statute limited an interest-expense deduction against unitary income to the extent that a corporation had certain nonunitary income. *Id.* at 461-62. In effect, the California statute required the taxpayer to allocate interest-expense deductions first against nontaxable, "nonunitary" income and only thereafter against taxable, "unitary" income. *Id.*

Because the limitation on deductions increased the amount of "unitary" income subject to tax, this Court held that the deduction limit functioned as a tax on the nonunitary income. *Id.* at 464-65. As a result, the deduction limit could be justified only if it "reflected the portion of the expense properly related to nonunitary income." *Id.* at 465. The California statute failed that test because it unrealistically assumed that "all borrowing first supports nonunitary investment." *Id.* at 467. Because that assumption "fail[ed] to 'actually reflect a reasonable sense of how income is generated,'" the Court concluded that California's statute was invalid. *Id.* at 466 (quoting *Container Corp.*, 463 U.S. at 169).

*Hunt-Wesson* confirms that, in the context of apportionment of income, a State may not limit a deduction (and thereby increase its share of the taxpayer's income) based on a factor that does not

---

<sup>5</sup> "Unitary income" includes "all income from a corporation's business activities, but excludes income that derives from unrelated business activity which constitutes a discrete business enterprise." *Hunt-Wesson*, 528 U.S. at 461 (internal quotation marks and alterations omitted). That "latter 'nonunitary' income normally is not taxable by any State except the corporation's State of domicile (and the States in which the 'discrete enterprise' carries out its business)." *Id.*

relate to the manner in which income is generated within the State. *Id.*

2. In conflict with *Hunt-Wesson* and its predecessors, Alabama's add-back statute limits VFJ's deductions for royalty payments in a manner wholly unrelated to VFJ's activity in Alabama. The add-back statute denies VFJ a deduction for an ordinary business expense because Lee and Wrangler are located in a State (Delaware) that has chosen not to tax the royalty payments they received from VFJ. That factor – the tax policy of a sister State – does not remotely “reflect a reasonable sense of how income is generated.” *Id.* (quoting *Container Corp.*, 463 U.S. at 169). Indeed, the tax policy of Delaware is irrelevant to VFJ's generation of income in Alabama. Whether VFJ made ordinary and necessary business payments to a company in Delaware (rather than a company in Georgia) should have no bearing on the amount of additional income tax that VFJ is required to pay in Alabama.

In concrete terms, if Lee and Wrangler were located in Georgia, rather than Delaware, VFJ's taxes in Alabama would decrease by about \$1 million even though its business activity in Alabama would not have changed at all. Pet. App. 15a. Likewise, if Delaware changed its laws to tax the royalty payments made to Lee and Wrangler, then VFJ's tax liability in Alabama would decrease, even though its business activity in Alabama had remained the same.

3. The Alabama Supreme Court's effort to distinguish *Hunt-Wesson* is baseless. See Pet. App. 59a-61a. The court below concluded that Alabama's application of VFJ's apportionment factors to the royalty payments to Lee and Wrangler resulted in Alabama taxing only the share of the royalty payments that are attributable to Alabama. *Id.* at

59a-60a. That reasoning ignores the antecedent issue – namely, the arbitrary manner in which the add-back statute determines whether *any* of the royalty payments are subject to tax. That Alabama ultimately taxes only a portion of the royalty payments made to Lee and Wrangler does not address the threshold requirement that State law “reflect a reasonable sense of how income is generated.” *Hunt-Wesson*, 528 U.S. at 466 (quoting *Container Corp.*, 463 U.S. at 169). If Delaware had chosen to tax the royalty payments to Lee and Wrangler, then Alabama would not have taxed VFJ in Alabama with respect to those payments. The decision below offers no logical connection between a sister State’s taxing policy and Alabama’s decision to deny a deduction (and thus increase the tax) on VFJ’s activities in Alabama.

Equally misguided was the Alabama Supreme Court’s conclusion that “the evidence did not demonstrate that the application of the add-back statute has resulted in taxation that is out of proportion to VFJ’s activities in this state.” Pet. App. 60a-61a (citing *Container Corp.*, 463 U.S. at 170; *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 274 (1978); *Oklahoma Tax Comm’n*, 514 U.S. at 185). That assertion ignores that a State’s apportionment formula must bear a rational relationship to the taxpayer’s activity “both on its face *and* in its application.” *Norfolk & W. Ry.*, 390 U.S. at 325 (emphasis added); 1 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 8.12[1], at 8-221 (3d ed. 2008) (“Hellerstein”) (“[A] question that should be resolved before a court addresses the fairness of the application of an apportionment formula is whether

the formula is fair on its face.”).<sup>6</sup> Here, the add-back statute is unconstitutional because it seeks to increase VFJ’s taxable income based not on activity in Alabama, but on the tax policy of a sister State. On its face, the add-back statute fails to “reflect a reasonable sense of how income is generated.” *Hunt-Wesson*, 528 U.S. at 466.

Lastly, the Alabama Supreme Court defended the add-back statute also by deeming deductions “a matter of legislative grace” that the State could deny at will. Pet. App. 56a. That analysis is contrary to *Hunt-Wesson*, which looked to the substantive effect of a State’s denial of a deduction, and concluded that it was an impermissible effort by the State to tax nonunitary income. 528 U.S. at 464-65. Under *Hunt-Wesson*, because Alabama’s denial of a deduction increases Alabama’s tax on VFJ (a multistate entity whose income Alabama may only tax in part), that

---

<sup>6</sup> In contrast, the decisions on which the Alabama Supreme Court relied addressed whether the apportionment method at issue yielded an unfair application only *after* concluding that the method was fair on its face. In *Container Corp.*, this Court rejected the taxpayer’s challenge to California’s three-factor formula because the taxpayer failed *either* to “impeach[] the basic rationale behind the three-factor formula” *or* to demonstrate that the formula resulted in “enormous distortions” that would warrant its invalidation. 463 U.S. at 182-84. *Moorman* concerned a challenge to Iowa’s single factor apportionment method, the facial validity of which the Court sustained as designed “to reach[] . . . only the profits earned within the State,” and therefore the taxpayer had to show that the formula “produced an arbitrary result in its case.” 437 U.S. at 274-75. And, in *Oklahoma Tax Comm’n*, the Court discussed at length whether the State could choose not to apportion a sales tax on interstate bus tickets, 514 U.S. at 186-95, before engaging in the separate inquiry whether that method resulted in a “grossly distorted result,” *id.* at 195-96 (internal quotation marks omitted).

deduction disallowance must be judged against fair-apportionment principles. Indeed, under the Alabama Supreme Court's reasoning, the California statute in *Hunt-Wesson* would not have violated the Constitution because it only denied a deduction, which the Alabama Supreme Court would view as "a matter of legislative grace." Pet. App. 56a.

The State of Delaware's policy decision not to tax the royalty income of Lee and Wrangler does not give Alabama the green light to increase VFJ's tax liability. By doing so, the add-back statute violates the Constitution by "reach[ing] beyond that portion of value that is fairly attributable to economic activity within [Alabama]." *Oklahoma Tax Comm'n*, 514 U.S. at 185.

## **II. REVIEW IS WARRANTED BECAUSE THIS CASE SQUARELY PRESENTS ISSUES OF SURPASSING IMPORTANCE TO TAXPAYERS AND STATES THROUGHOUT THE COUNTRY.**

Review is warranted because the decision below conflicts with this Court's decisions setting forth the limits imposed by the Commerce Clause and Due Process Clause on state taxing authority. See Sup. Ct. R. 10(c). Prompt resolution of that conflict is critically important because nearly 20 other States have adopted similar add-back statutes that discriminate against interstate commerce in a manner forbidden by this Court's cases. A decision by this Court now would provide necessary certainty in this important area of the law, thereby obviating or diminishing the need for costly refund actions by taxpayers should this Court later conclude that these add-back statutes violate the United States Constitution. Both taxpayers and States throughout

the Nation would therefore benefit from immediate review of the decision below.

1. This Court has long recognized that the Commerce Clause guarantees "a national economic union unfettered by state-imposed limitations." *Healy*, 491 U.S. at 335-36. As such, this Court has granted review in Commerce Clause cases even where "the facts of this particular case, viewed in isolation, do not appear to pose any threat to the health of the national economy." *Camps Newfound*, 520 U.S. at 595; *Fulton*, 516 U.S. at 333 n.3 ("[W]e have never recognized a '*de minimis*' defense to a charge of discriminatory taxation under the Commerce Clause"). This Court has done so because "[t]he history of [the Court's] Commerce Clause jurisprudence has shown that even the smallest scale discrimination can interfere with the project of our Federal Union." *Camps Newfound*, 520 U.S. at 595.

Review is warranted in this case because Alabama's add-back statute strikes at the heart of these constitutional principles and does so on a grand scale. By denying a deduction to taxpayers who transact with businesses in certain other States, Alabama contravenes the non-discrimination principle that animates this Court's Commerce Clause jurisprudence. See, e.g., *New Energy*, 486 U.S. at 275 (Commerce Clause prevents the imposition of "an economic disadvantage upon out-of-state sellers"); *West Lynn Creamery*, 512 U.S. at 201 ("In each case it is our duty to determine whether the statute under attack, whatever its name may be, will in its practical operation work discrimination against interstate commerce."). Further, Alabama's add-back statute impermissibly attempts to project Alabama's tax policy extraterritorially by denying Alabama taxpayers otherwise available benefits if they deal

with businesses in States that do not share Alabama's policy of taxing royalty payments. See *Fulton*, 516 U.S. at 333 n.3; *Healy*, 491 U.S. at 334.

In this case alone, application of the add-back statute has increased VFJ's Alabama tax liability by over \$1 million for a single tax year because VFJ made royalty payments to corporations located in Delaware, rather than corporations located in Alabama (or another State that shares Alabama's policy of taxing these royalty payments). Accordingly, even if Alabama's add-back statute were unique, the decision below would warrant this Court's review. *E.g.*, *Polar Tankers, Inc. v. City of Valdez*, No. 08-310 (cert. granted Dec. 12, 2008); *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000); *South Cent. Bell Tel. Co. v. Alabama*, 526 U.S. 160 (1999).

2. Alabama's add-back statute, however, is not unique. As the courts below recognized, nearly 20 other States have enacted similar add-back statutes disallowing deductions for interest and intangibles expenses. Pet. App. 12a n.3; see John C. Healy & Michael Schadewald, *Multistate Corporate Tax Guide* I-417 (2008) (citing state statutes). Although these add-back statutes vary in certain particulars, nearly all include a subject-to-tax exception of the sort contained in the Alabama statute at issue here.<sup>7</sup>

---

<sup>7</sup> See Ark. Code Ann. 26-51-423(g)(1) ("A deduction . . . for interest or intangible-related expenses paid by the taxpayer to a related party shall be allowed only if: (A) The interest or intangible-related income received by the related party is subject to income tax imposed by the State of Arkansas, another state, or a foreign government . . ."); accord Ga. Code Ann. § 48-7-28.3(d)(2); 35 Ill. Comp. Stat. 5/203(a)(2)(D-18); Ind. Code § 6-3-2-20(c)(2); Ky. Rev. Stat. Ann. § 141.205(3)(b); Mich. Comp. Laws § 208.1201(2)(f)(ii); Ohio Rev. Code Ann. §§ 5733.042, .055(A)(2); Va. Code Ann. § 58.1-402(B)(8)(a)(1). Several States

Commentators have emphasized the constitutional issues raised by these add-back statutes.<sup>8</sup> As such, the need for review in this case is more pronounced because a ruling on Alabama's add-back statute likely will have an impact not only in Alabama but also in these other States that have analogous statutes. See *Nixon*, 528 U.S. at 385 (granting certiorari to assess conflict with prior Court ruling "[g]iven the large number of States that limit political contributions"); see also Robert L. Stern et al., *Supreme Court Practice* 246 (8th ed. 2002) (citing cases that highlight the importance of "the impact of the ruling below upon the validity of similar statutes in other states").

Moreover, the Multistate Tax Commission – a coalition of States that excludes Delaware and Nevada – has advocated that member States adopt

---

allow the deduction only if the related payments are subject to tax above a certain rate. See Conn. Gen. Stat. § 12-218(c); D.C. Code § 47-1803.03(a)(19)(B); Md. Code Ann., Tax-Gen. § 10-306.1(c); Mass. Gen. Laws ch. 63, § 31I; 830 Mass. Code Regs. 63.31.1; R.I. Gen. Laws § 44-11-11(f)(3). Two States allow the deduction only if the related payments are subject to tax in those States. See N.J. Stat. Ann. § 54:10A-4.4; N.J. Admin. Code § 18:7-5.18(b)(3); N.C. Gen. Stat. 105-130.7A.

<sup>8</sup> See, e.g., Charles F. Barnwell, *Addback: It's Payback Time*, 50 State Tax Notes 437 (Nov. 17, 2008) (surveying add-back statutes and noting that they "raise facial constitutional issues"); Giles Sutton & Todd Zoellick, *The Ins and Outs of Related Party Add-Backs*, Tax Executive 139, 143 (May-June 2005) (noting that add-back statutes are constitutionally suspect because they alter corporations' incentives to organize in certain states); Thomas H. Steele & Pilar M. Sansone, *Surveying Constitutional Theories for Challenges to the Addback Statutes*, 35 State Tax Notes 613, 620 (Feb. 28, 2005) ("Perhaps the most fundamental constitutional question presented by the addback statutes is whether a state, by its tax regime, may effectively penalize a taxpayer for doing business with an affiliate that operates in another state with a favorable tax regime.").

its model add-back statute. See Multistate Tax Comm'n, *Model Statute Requiring the Add-back of Certain Intangible & Interest Expenses* (Aug. 17, 2006) <http://www.mtc.gov/Uniformity.aspx?id=500&ItemId=500>. The proliferation of these add-back statutes will lead directly to the "economic Balkanization" that this Court's "Commerce Clause jurisprudence has long sought to prevent." *Fulton*, 516 U.S. at 333 n.3 (quoting *Hughes*, 441 U.S. at 325-26). Given the stakes involved, it is no surprise that the decision below has generated significant analysis by commentators of the constitutional issues implicated in these add-back statutes.<sup>9</sup>

3. This Court should provide necessary clarity by reviewing the decision below now. At present, States are administering add-back statutes under a cloud of uncertainty. If this Court invalidates these add-back statutes, offending States will be required "to provide meaningful backward-looking relief" to any injured taxpayer. See *McKesson Corp.*, 496 U.S. at 31. That

---

<sup>9</sup> See, e.g., Sarah McGahan, *The "Unreasonable" Exception to Addback*, [19-Aug.] J. of Multistate Tax'n & Incentives 6, 7 (2008) (noting that "state tax professionals followed [the decision below] closely"); Donald M. Griswold, *Addbacks Add Nothing to the Debate*, 48 State Tax Notes 1073 (June 30, 2008) (critiquing the decision below and contending that Alabama's add-back statute is unconstitutional); Thomas H. Steele & Pilar M. Sansone, *Alabama's Addback Case: The Trial Court Got It Right*, 48 State Tax Notes 593 (May 19, 2008) (critiquing the decision below and arguing that a State may not "discriminat[e] based on another state's decision to adopt a more favorable tax regime"); cf. Walter Hellerstein & John Swain, *Further Thoughts on the 'Subject to Tax' Exception in State Corporate Income Tax Expense Disallowance Statutes*, 48 State Tax Notes 597 (May 19, 2008) (approving the decision below but expressing doubt as to the statute's constitutionality because it denies the deduction for royalty payments that are taxable in another State).

relief will often consist of a retroactive refund payments because many States, like Alabama, require taxpayers to pay the tax (or pledge equivalent assets) before obtaining a meaningful opportunity to challenge the tax. *See id.* at 38 n.21; see Ala. Code § 40-2A-9(g)(b).

The longer States continue enforcing add-back statutes, the more States may eventually be forced to refund. Given the amount of taxes at issue, delay of just a few years will result in States facing enormous potential refund liabilities. Even in States that offer a meaningful pre-deprivation procedure, lingering doubts about add-back statutes will invite taxpayers' challenges, which create substantial administrative costs. Hellerstein, *supra*, ¶ 7.17[3][d] ("In light of the . . . enormous amounts of money at stake, these statutes inevitably will spawn a significant amount of litigation . . .") (footnote omitted).<sup>10</sup> Those burdens are particularly noteworthy given this Court's recognition of "the imperative need of a State to administer its own fiscal operations." *Tully v. Griffin, Inc.*, 429 U.S. 68, 73 (1976). Under these circumstances, the need for prompt resolution of this issue would benefit not only taxpayers, but also the States that have adopted these statutes and other States that may follow suit.

Moreover, the decision below provides an ideal vehicle for this Court to resolve the constitutionality of these add-back statutes. The parties in this case litigated the constitutional issues vigorously, creating

---

<sup>10</sup> *See, e.g., Family Dollar Stores of Ohio, Inc. v. Wilkins*, No. 2005-V-469, 2008 Ohio Tax LEXIS 5 (Ohio Bd. of Tax Appeals Jan. 4, 2008); *Virginia Dep't of Taxation*, P.D. 07-153, 2007 Va. Tax LEXIS 155 (Oct. 2, 2007); *Deluxe Fin. Servs., Inc. v. Director, Div. of Taxation*, No. 005522-2006 (N.J.T.C. filed May 30, 2006).

a comprehensive record during a multi-day trial in which “the premier experts in the fields of taxation and patents and trademarks” detailed how the Alabama add-back statute operates. Pet. App. 66a. In turn, the Alabama Court of Civil Appeals and the Alabama Supreme Court thoroughly, albeit incorrectly, addressed and passed on each of the constitutional claims at issue in this case, thereby giving this Court a comprehensive platform for review of the important constitutional questions presented by this petition. Thus, the value of allowing the issue to “percolate” in the lower courts is clearly outweighed by the importance of immediate guidance from this Court.

### CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

KEVIN C. NEWSOM  
JOHN C. NEIMAN, JR.  
BRADLEY ARANT BOULT  
CUMMINGS LLP  
One Federal Place  
1819 Fifth Avenue North  
Birmingham, AL 35203  
(205) 521-8000

CARTER G. PHILLIPS\*  
PAUL J. ZIDLICKY  
MATTHEW D. KRUEGER  
SIDLEY AUSTIN LLP  
1501 K Street, N.W.  
Washington, D.C. 20005  
(202) 736-8000

*Counsel for Petitioner*

January 21, 2009

\* Counsel of Record

1a

**APPENDIX A**

**SUPREME COURT OF ALABAMA**

---

1070718

---

Ex parte VFJ VENTURES, INC., f/k/a VF JEANSWEAR,  
INC.;

(In re: G. THOMAS SURTEES, in his official capacity as  
commissioner of the Alabama Department of  
Revenue, and the Alabama Department of Revenue

v.

VFJ VENTURES, INC., f/k/a VF JEANSWEAR, INC.)

---

**PETITION FOR WRIT OF CERTIORARI  
TO THE COURT OF CIVIL APPEALS**

---

September 19, 2008, Released  
As Corrected September 25, 2008.

---

**OPINION**

JUDGES: LYONS, Justice. Cobb, C.J., and See,  
Woodall, Stuart, Smith, Bolin, Parker, and Murdock,  
JJ., concur.

**OPINION BY: LYONS**

LYONS, Justice.

VFJ Ventures, Inc., f/k/a VF Jeanswear, Inc.  
("VFJ"), sued in the Montgomery Circuit Court the  
commissioner of the Alabama Department of

Revenue, in his official capacity, and the Alabama Department of Revenue. At the time the complaint was filed, Dwight Carlisle was the commissioner of the Alabama Department of Revenue. During the pendency of the case, G. Thomas Surtees was substituted pursuant to Rule 25(d), Ala. R. Civ. P., as a defendant, in his official capacity, when he became the commissioner of the Alabama Department of Revenue. Tim Russell is now the commissioner of the Alabama Department of Revenue; he is now a defendant, in his official capacity, pursuant to Rule 43(b), Ala. R. App. P. (Russell and the Alabama Department of Revenue will hereinafter be referred to collectively as "the Department.") The trial court entered a judgment in favor of VFJ. The Department appealed to the Court of Civil Appeals; that court reversed the judgment of the trial court and remanded the case for the entry of a judgment in favor of the Department. *Surtees v. VFJ Ventures, Inc.*, [Ms. 2060478, February 8, 2008] So. \_\_ 2d \_\_, (Ala. Civ. App. 2008). VFJ then filed a petition for certiorari with this Court; we granted certiorari review.

After considering the record in this case, the briefs of the parties and the amici curiae, the oral arguments of the parties, and the opinion of the Court of Civil Appeals, we agree with the views expressed by Presiding Judge Thompson in his thorough and well reasoned opinion. In light of that thoughtful opinion, we see no need to explicate further. We affirm the judgment of the Court of Civil Appeals, and we adopt Presiding Judge Thompson's opinion in its entirety, as the opinion of this Court.

AFFIRMED

3a

Cobb, C.J., and See,<sup>1</sup> Woodall, Stuart, Smith, Bolin,  
Parker, and Murdock, JJ., concur.

---

<sup>1</sup> Although Justice See did not sit for oral argument of this case, he has viewed the video recording of that oral argument.

**APPENDIX B**

**COURT OF CIVIL APPEALS OF ALABAMA**

---

2060478

---

G. THOMAS SURTEES, in his official capacity as  
commissioner of the Alabama Department of  
Revenue, and the Alabama Department of Revenue

v.

VFJ VENTURES, INC., f/k/a VF JEANSWEAR, INC.

---

February 8, 2008, Released  
As Corrected October 22, 2008.

---

**OPINION**

JUDGES: THOMPSON, Presiding Judge. Thomas  
and Moore, JJ., concur. Pittman and Bryan, JJ., con-  
cur in the result, without writings.

**OPINION BY: THOMPSON**

THOMPSON, Presiding Judge.

VFJ Ventures, Inc. ("VFJ"), f/k/a VF Jeanswear, Inc., filed an appeal in the Montgomery Circuit Court ("the trial court") pursuant to § 40-2A-7(b)(5)(b), Ala. Code 1975, challenging a decision of the Alabama Department of Revenue assessing against VFJ an amount representing additional corporate income tax purportedly owed the State; it also named the commissioner of the Department as a defendant.<sup>1</sup> We re-

---

<sup>1</sup> VFJ named "Dwight Carlisle, in his official capacity as the commissioner of the Department of Revenue" as a defendant; it

fer to the two named defendants collectively as “the Department.”

The Department responded, arguing that the assessment should be upheld. The Department later filed a motion for a partial summary judgment, which the trial court denied. The trial court conducted a lengthy trial at which evidence was presented ore tenus and numerous exhibits submitted. The trial court also accepted posttrial briefs from the parties. On January 24, 2007, the trial court entered a judgment in favor of VFJ. The Department timely appealed to this court pursuant to § 12-3-10, Ala. Code 1975.

VFJ manufactures and sells jeanswear sold under the Lee® and Wrangler® brand names in the United States. VFJ has two distribution facilities and a “cutting” facility in Alabama. Those facilities employ approximately 600 people. In 2001, the tax year at issue in this case, VFJ’s gross sales were approximately \$2.1 billion; only a portion of VFJ’s gross sales were attributable to its activities in Alabama. “Under both the Due Process and the Commerce Clauses of the [United States] Constitution, a state may not, when imposing an income-based tax, ‘tax value earned outside its borders.’” *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164, 103 S. Ct. 2933, 77 L. Ed. 2d 545 (1983) (quoting *ASARCO, Inc. v. Idaho State Tax Comm’n*, 458 U.S. 307, 315, 102 S. Ct. 3103, 73 L. Ed. 2d 787 (1982)). Thus, only that part of VFJ’s income that was fairly attributable to

---

later substituted G. Thomas Surtees as a defendant in place of Carlisle when Surtees came to hold the office of commissioner of the Department of Revenue. See Rule 25(d), Ala. R. Civ. P.

its presence in Alabama is subject to taxation in this state.

When a corporation such as VFJ has manufacturing facilities or operating facilities or performs activities in more than one state, a formula known as an "apportionment factor" is used to determine how much income is attributable to each state. The apportionment factor is used to determine the portion of the corporation's income that is subject to income tax in each of the states in which the corporation has activity. See *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 778, 112 S. Ct. 2251, 119 L. Ed. 2d 533 (1992) ("Because of the complications and uncertainties in allocating the income of multistate businesses to the several States, we permit States to tax a corporation on an apportionable share of the multistate business carried on in part in the taxing State."). In this case, the Department and VFJ seem to have agreed on the application of a common three-part apportionment factor that has been approved by the United States Supreme Court. See *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. at 170 ("[N]ot only has the three-factor formula met our approval, but it has become . . . something of a benchmark against which other apportionment formulas are judged.").

Alabama, like a number of other states, has adopted the apportionment factor referenced in *Container Corp. of America v. Franchise Tax Bd.*, supra, for determining the portion of a multistate corporation's income that may be taxed in this state. The apportionment factor is set forth in § 40-27-1, Art. IV, ¶ 9, Ala. Code 1975, as a part of Alabama's adoption of the Multistate Tax Compact. The Multistate Tax Compact creates a uniform system for taxing entities

such as VFJ, who have operations or are active in more than one state. *State Dep't of Revenue v. MGH Mgmt., Inc.*, 627 So. 2d 408, 408-09 (Ala. Civ. App. 1993) ("The [Multistate] Tax Compact provides for the allocation and apportionment of income of taxpayers doing business in more than one state in such a manner as to avoid duplicative taxation.").

In opening statements during the trial of this matter, one of the attorneys accurately summarized Alabama's apportionment factor for the trial court as follows:

"You take the ratio of the property in the state to the property out of state, a ratio of the sales in the state to the sales out of the state, a ratio of the payroll in the state to the sales [sic] out of the state, add them together and divide by three, and that average is your apportionment factor."

For the 2001 tax year, VFJ's apportionment factor for Alabama was 13.9299%. Using that factor, VFJ reported approximately \$13,702,000 in income to be apportioned to Alabama on its state corporate income-tax return for the 2001 tax year.

VFJ is a subsidiary of VF Corporation ("VF"), a parent holding company comprising hundreds of subsidiaries worldwide. VF's corporate headquarters is located in Greensboro, North Carolina. Among VF's subsidiaries are numerous intangible management companies ("IMCOs") that own and manage trademarks, most of which are used by other VF subsidiaries. All the IMCOs are Delaware corporations.

A treatise on state taxation has explained the function of IMCOs like those in the VF corporate family as follows:

“One of the standard tax-planning devices corporations employ to reduce taxable income in states where they conduct their operations is to transfer their trademarks or trade names to an intangibles holding company ([IMCO]) and license back the trademarks or trade names for a royalty. The royalty, which is deductible to the operating company, reduces its income in the states where it carries on its business. The [IMCO], on the other hand, ordinarily pays no tax on its royalty income because it is taxable—or at least taxpayers so contend—only in a state that does not tax such income (e.g., Delaware).”

J. Hellerstein & W. Hellerstein, *State Taxation* ¶ 9.20[3][j] (2007 Cum. Supp.).

Two of the IMCOs in the VF corporate family are the H.D. Lee Company, Inc. (“Lee”), and the Wrangler Clothing Corporation (“Wrangler”), which own and manage trademarks for Lee® and Wrangler® brands, respectively. Lee and Wrangler license their respective trademarks to VFJ and other VF subsidiaries, as well as to third parties. It is undisputed that VFJ and the other subsidiaries of VF, including Lee and Wrangler, are “related members” as that term is defined for the purpose of determining Alabama’s corporate income tax.<sup>2</sup> Testimony at trial indicated

---

<sup>2</sup> Section 40-18-1(18), Ala. Code 1975, defines the term “related member” as:

“A person that, with respect to the taxpayer any time during the taxable year, is a related entity as defined in this section, a component member as defined in 26 U.S.C. § 1563(b) of a controlled group of which the taxpayer is also a component, or is a person to or from whom there is attribution of stock ownership in accordance with 26 U.S.C. § 1563(e).”

that Lee and Wrangler generally charge a 5% royalty rate to both related-member and third-party licensees. In 2001, the tax year at issue, approximately 78% of Lee's income came from licensing agreements with related members. For that same year, approximately 97% of Wrangler's licensing income was derived from licensing agreements with related members.

In Delaware, IMCOs such as Lee and Wrangler are subject to taxation only under limited circumstances. See Del. Code Ann. tit. 30, § 1902. Because the royalty payments are generally deductible expenses as to the licensee operating companies, the royalty payments made by related-member licensees that comprise the corporate income of the IMCOs escape taxation on the state level. Accordingly, the creation of the Delaware IMCOs created significant state-tax savings for VFJ and other subsidiaries of VF by effectively shifting income out of states that do impose corporate income tax to a state that does not impose such a tax.

To illustrate this process, the record indicates that in 2001 VFJ paid Lee \$36,220,000 in licensing royalty fees for its use of the Lee® trademarks on its products, and it paid Wrangler \$66,420,000 for the use of its Wrangler® trademarks. On its 2001 federal income-tax return, VFJ deducted those royalty payments as ordinary and necessary business expenses, see 26 U.S.C. § 162, thereby reducing the amount of its federal taxable income. Because federal taxable income is the starting point for the calculation of taxable income in Alabama, see § 40-18-33, Ala. Code 1975, the deduction of those royalty payments as business expenses also served to reduce VFJ's taxable income in Alabama. Thus, the royalty payments

VFJ made to Lee and Wrangler for the use of their trademarks in its operating facilities in Alabama and other states worked to transfer funds out of this state, which has a corporate income tax, to the Delaware IMCOs, thereby ensuring that those royalty payments could not be subjected to taxation on the state level. In the 2000 tax year, the use of the practice of making royalty payments to the related-member IMCOs resulted in a total state-tax savings for VFJ (for its total operations, not just those in Alabama) of approximately \$ 5.5 million. VFJ's 2001 state-tax savings as a result of royalty payments to the related-member IMCOs was approximately \$ 6 million.

The payment of royalty fees to a related member located in a jurisdiction that does not impose a state corporate income tax works to avoid state taxation only in states known as "separate-entity" or "separate-reporting" states. In those states, including Alabama, each entity in a corporate group that has activity in the state must file a separate corporate income-tax return in the state. The basis of taxation is the amount of income earned within the state by the individual corporate entity. In a separate-reporting state, "each part of an affiliated group of corporations is treated as a separate entity" for the purpose of determining the amount of taxable income to be apportioned to that state. *E.g., Bridges v. Auto-Zone Props., Inc.*, 900 So. 2d 784, 792 (La. 2005). Other states allow a practice known as "combined reporting," pursuant to which a taxing state treats a group of commonly owned companies, such as VF and its subsidiaries, as a single taxpayer. In a combined-reporting state, the incomes of the various members of the group are combined and a formula is applied to determine what portion of the entire group's income

is attributable to, and therefore taxable in, that state. See *Citizens Utils. Co. of Illinois v. Department of Revenue*, 111 Ill. 2d 32, 40, 488 N.E.2d 984, 987, 94 Ill. Dec. 737, 740 (1986) (containing a thorough discussion of the difference in the methods of taxation of combined-reporting states and separate-entity states). In combined-reporting states, transactions between related members do not work to shift income because all income from the various members of the corporate group (including IMCOs) is included in the determination of taxable income for that state.

The difference between combined-reporting states and separate-entity states has been aptly illustrated as follows:

"Intercompany arrangements of this type [IMCOs] do not reduce state income taxes in 'combined reporting' states, that is, states which require an affiliated group of corporations engaged in a common enterprise (a 'unitary business'), part of which is conducted in the state, to file a combined income tax return. In those states, the [IMCO] ordinarily must be included in the combined return, and the intercompany transactions are eliminated. . . .

"In 'separate reporting' states, that is, states in which each corporation [even within a corporate family] files a separate income tax return, a number of state tax administrators have attempted to tax the income of out-of-state [IMCOs] that were not physically present in the state but earned income from licensing intangible assets to related corporations that conducted business in the state."

James A. Amdur, *State Income Tax Treatment of Intangible Holding Companies*, 11 A.L.R. 6th 543, 553 (2006).

As indicated earlier, Alabama is a separate-reporting state. Alabama requires certain adjustments to the federal taxable-income amount in order to determine the amount of state taxable income. § 40-18-33, Ala. Code 1975. The Alabama Legislature created one such adjustment when it enacted Act No. 2001-1088, Ala. Acts 2001, which amended § 40-18-35, Ala. Code 1975, to add subsection (b). Subsection (b) of § 40-18-35 is now referred to as Alabama's "add-back" statute.<sup>3</sup>

Alabama's add-back statute restricts the deductibility of certain intangible and interest expenses for the purpose of calculating state taxable income. Although Alabama's add-back statute was enacted in December 2001, the Alabama Legislature specified that the statute was effective "for all tax years beginning subsequent to December 31, 2000." *See* Act No.

---

<sup>3</sup> In addition to Alabama, the following separate-reporting states also have add-back statutes: Arkansas, *see* Ark. Code Ann. § 26-51-423(g)(1); Connecticut, *see* Conn. Gen. Stat. § 12-218(c); District of Columbia, *see* D.C. Code § 47-1803.02; Georgia, *see* Ga. Code Ann. § 48-7-28.3; Illinois, *see* 35 Ill. Comp. Stat. 5/203(a)(2); Indiana, *see* Ind. Code § 6-3-2-20; Kentucky, *see* Ky. Rev. Stat. Ann. § 141.205; Maryland, *see* Md. Code Ann., Tax-Gen. § 10-306.1; Massachusetts, *see* Mass. Gen. Laws ch. 63, § 31I; Michigan, *see* Mich. Comp. Laws § 208.1201; Mississippi, *see* Miss. Code Ann. § 27-7-17; New Jersey, *see* N.J. Stat. Ann. § 54:10A-4.4; New York, *see* N.Y. Tax Law § 208; North Carolina, *see* N.C. Gen. Stat. § 105-130.7A; Ohio, *see* Ohio Rev. Code Ann. § 5733.042; South Carolina, *see* S.C. Code Ann. § 12-6-1130; Tennessee, *see* Tenn. Code Ann. § 67-4-2006(b); and Virginia, *see* Va. Code Ann. § 58.1-402(B).

2001-1088, § 10. Therefore, the add-back statute applied to the 2001 tax year.

Alabama's add-back statute provides, in relevant part:

“(b) Restrictions on the deductibility of certain intangible expenses and interest expenses with a related member.

“(1) For purposes of computing its taxable income, a corporation shall add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions, with one or more related members, except to the extent the corporation shows, upon request by the commissioner, that the corresponding item of income was in the same taxable year: a. Subject to a tax based on or measured by the related member's net income in Alabama or any other state of the United States, or b. subject to a tax based on or measured by the related member's net income by a foreign nation which has in force an income tax treaty with the United States, if the recipient was a 'resident' (as defined in the income tax treaty) of the foreign nation. For purposes of this section, 'subject to a tax based on or measured by the related member's net income' means that the receipt of the payment by the recipient related member is reported and included in income for purposes of a tax on net income, and not offset or eliminated in a combined or consolidated return which includes the payor.

"(2) The corporation shall make the adjustments required in subdivision (1) unless the corporation establishes that the adjustments are unreasonable, or the corporation and the Commissioner of Revenue agree in writing to the application or use of alternative adjustments and computations. Nothing in this section shall be construed to limit or negate the commissioner's authority to otherwise enter into agreements and compromises otherwise allowed by law.

"(3) The adjustments required in subdivision (1) shall not apply to that portion of interest expenses and costs and intangible expenses and costs if the corporation can establish that the transaction giving rise to the interest expenses and costs or the intangible expenses and costs between the corporation and the related member did not have as a principal purpose the avoidance of any Alabama tax and the related member is not primarily engaged in the acquisition, use, licensing, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property, or in the financing of related entities. If the transaction giving rise to the interest expenses and costs or intangible expenses and costs, as the case may be, has a substantial business purpose and economic substance and contains terms and conditions comparable to a similar arm's length transaction between unrelated parties, the transaction will be presumed to not have as its principal purpose tax avoidance, subject to rebuttal by the Commissioner of the Department of Revenue."

Thus, Alabama's add-back statute requires that a corporation add back into its taxable income expenses and costs related to intangibles such as trademarks that are paid to a related member. In this case, the Department contends that, subject to § 40-18-35(b), the royalty payments VFJ made to Lee and Wrangler during the 2001 tax year must be added to VFJ's federal taxable income for the purpose of calculating VFJ's taxable income in Alabama.

It is undisputed that the royalty payments VFJ made to Lee and Wrangler in 2001 for the use of the IMCOs' trademarks were the type of intangible expenses referenced in Alabama's add-back statute. VFJ deducted those royalty payments from its federal taxable income, and, therefore, those deductions flowed through to the starting point of corporate net income subject to taxation in Alabama. Accordingly, unless one of the three exceptions set forth in § 40-18-35(b)(1), (2), or (3), applies, Alabama's add-back statute requires that those deductions for intangible expenses paid to the related IMCOs be added back into the calculation of VFJ's taxable income for Alabama.

In calculating and paying its Alabama corporate income tax for the 2001 tax year, VFJ did not add back into the calculation of its taxable income the intangible expenses required to be added by Alabama's add-back statute. The Department conducted an audit of VFJ's corporate tax return for the 2001 tax year. Thereafter, the Department issued a notice of final assessment to VFJ, demanding payment of an additional \$1,019,899 in state taxes. The vast majority of that assessment was attributable to the Department's inclusion, based on the add-back statute, in the Department's determination of VFJ's taxable

income of the royalty payments VFJ made to Lee and Wrangler for the use of the trademarks of those IMCOs. VFJ has challenged only the portion of the assessment attributable to the add-back statute.

In the trial court, VFJ challenged that part of the Department's assessment that was based on the application of the add-back statute. VFJ argued that the add-back statute should not apply, based on certain exceptions contained in the statute. Specifically, VFJ maintained that the royalty payments had been subject to taxation in another jurisdiction, *see* § 40-18-35(b)(1), and that the application of the add-back statute was unreasonable because the royalty payments to Lee and Wrangler had a legitimate business purpose and economic substance, *see* § 40-18-35(b)(2). VFJ also challenged the constitutionality of Alabama's add-back statute. The Department responded and insisted that the assessment was valid. Later, in its motion for a partial summary judgment, the Department argued that VFJ's argument regarding the business purpose and economic substance of the IMCOs was not relevant to a determination of unreasonableness under § 40-18-35(b)(2).

The trial court received ore tenus evidence and heard the arguments of the parties during a four-day trial. In addition, each party submitted numerous exhibits. Much of the evidence pertained to VFJ's attempt to demonstrate that the Lee and Wrangler IMCOs had legitimate business purposes and economic substance, and, therefore, according to VFJ's argument, application of the add-back statute would be unreasonable. Some of the evidence presented at the trial was summarized by the trial court in its judgment as follows:

“At trial, VFJ established several other purposes [other than the avoidance of state taxation] for segregating the ownership and management of [VF’s] trademarks into the IMCOs. Centralization of trademarks increased efficiency by concentrating management in one group of employees instead of being spread throughout the various operating subsidiaries around the world. Centralization also allowed the employees to develop the expertise necessary to maintain the necessary registrations and monitor and combat infringement worldwide. The centralization and specialization also reduced duplicative efforts, costs, and reliance on outside counsel, increasing efficiency. VF was able to save at least \$ 60,000 per month in fees paid to outside counsel when it began its centralized trademark management.

“Centralization of trademark management allowed third party licensing efforts to be coordinated and managed. It also allowed easier monitoring of expenses and revenues associated with the intangible assets. Furthermore, centralization of intangible property was also part of a larger effort by [VF] in the 1990s to begin sharing common services (such as data processing, information technology, payroll, treasury, employee benefits and legal services) to capitalize on economics of scale.

“The parties vigorously disputed at trial whether segregation of the different families of trade-marks into different IMCOs facilitated the ease of sale of VF companies or lines of business. I find that the evidence established that in VF’s history of both selling and purchasing several lines of business, such sales were facilitated by

having the intangibles owned by an IMCO, thereby avoiding the need to transfer and assign each trademark, which could require thousands of assignments and filings around the world. VF in fact sold two IMCOs, Healthtex Apparel Corp., and Jantzen Apparel Corp., to third party purchasers in recent years and found that the IMCO structure facilitated the transfer of the intangibles.

“Segregating the intangible assets into separate management companies provided a more flexible business structure in other ways as well. For example, this structure would give the affiliated group more options in the case of a hostile takeover. It also became easier for the affiliated group to borrow money when it could demonstrate that the IMCOs had valuable assets as potential collateral and steady streams of income, without potential for unforeseen liabilities. The use of several different IMCOs ensured clean title to the different families of trademarks, and segregated the liabilities of the operating companies from the very valuable intangible assets. It also made it easier to track the profitability of the different families of trademarks.

“There were also several advantages to incorporating the IMCOs in Delaware. Delaware has advanced and favorable corporate law, and the U.S. District Court of Delaware has developed a specialty in intellectual property law. Delaware has an experienced workforce with experienced service providers in the intellectual property area.

“[VFJ] did an excellent job during the course of this trial convincing the Court that Lee and

Wrangler are not merely 'shell' corporations, but carry on substantial activities. The Court had the benefit of watching a videotape which set out the entire operation in Delaware. They had 3,200 square feet of office space in Wilmington, Delaware. Lee currently has at least fifteen employees, including two trademark attorneys, six trademark paralegals, one licensing paralegal, three trademark assistants, controller, staff accountant, and receptionist. These employees perform work for Wrangler as well. There was no question that this is a 'working office,' not just an empty space with a post office box.

"The [IMCO] employees monitor and maintain thousands of trademark registrations throughout the world. They license trademarks to VF affiliates like VFJ and also to numerous third parties. In 2001, approximately 22% of Lee's royalty income and 3.2% of Wrangler's royalty income were derived from third parties. Helen Winslow, assistant general counsel of Lee, reviews license applications from third parties and has the authority to turn down a license application from a potential licensee whose products might tarnish a brand's image or raise liability issues. Ms. Winslow can and often does require a test period for a new licensee or grant a license only in a certain geographic territory. Ms. Winslow engages in negotiations with the licensee, licensee's counsel, and usually a representative from a VF manufacturing company in order to set the terms of the license. Ms. Winslow, a past president of the Delaware State Bar Association, does not merely rubber stamp any paper brought to Lee by a related company.

"The IMCOs generally charged the same arm's-length rates for intercompany license agreements as third-party license agreements. The general rule was a flat 5% license or royalty fee, as determined by industry standards.

" . . . The IMCOs then negotiated with potential licensees in order to ensure the quality standards were sufficiently high that the licensees' use of the trademarks would not harm their value. If the standards were acceptable, the IMCO adopted those quality standards for the license; if the potential licensee would not agree to sufficiently high quality standards, no license was granted.

"In order to ensure compliance with the standards, the IMCOs entered into 'Technical Assistance and Know-How Agreements' with related VF manufacturing companies. In these agreements, the manufacturing entity agreed to provide certain technical assistance to the entities to which the IMCOs licensed particular trademarks. The assistance included provision of technical know-how and expertise with respect to the design, manufacture, quality control, promotion, marketing and distribution of the branded products. In exchange, the IMCOs reimbursed the manufacturing company for all costs associated with such consulting plus 5%.

"The IMCOs monitored all licenses, both VF and third-party, for proper trademark usage. In addition, the IMCOs hired third parties to investigate licensees' factories and ensured that the affiliated group's centralized audit group also investigated factories for quality control. The inspection program also ensured proper

quality control over the goods manufactured by [the] licensees.

“Lee and Wrangler also engaged in monitoring for potential trademark infringements. The IMCO staff received and reviewed ‘watch service’ reports daily to monitor for trademark applications claiming rights in trademarks that resembled Lee’s or Wrangler’s trademarks. They also reviewed weekly the Official Gazette, a publication of the U.S. Patent and Trademark Office that lists all approved trademark applications. If an IMCO discovered a potential infringement, it took steps to protect its trademarks, including filing court proceedings against the potential infringers if necessary.

“VFJ entered into license agreements with Lee and Wrangler that governed the licensing arrangement; these agreements contained terms comparable to those in the IMCOs’ agreements with third parties. There is no dispute that the 5% royalty rate was an arm’s length rate. Pursuant to these license agreements, VFJ paid royalties in cash to Lee and Wrangler for the use of their trademarks based on the amount of VFJ’s sales. VFJ transferred cash to Lee and Wrangler when making royalty payments.”

In addition to the foregoing, VFJ presented the testimony of Professor Richard Pomp, an expert witness in the area of state and local taxation, who testified that there are no add-back statutes of which he approves. He characterized Alabama’s add-back statute as “overbroad [and] overreaching.” Pomp testified that royalties on intangibles are business expenses that should be deducted in determining taxable income regardless of whether the royalty payments are

made to a related-member company. In Pomp's opinion, the appropriate inquiry in determining whether the application of an add-back statute is unreasonable is whether the deduction is truly one for a legitimate or ordinary and necessary business expense.

According to Pomp, the determination of whether it is unreasonable to require a corporation to comply with the add-back statute should focus on whether there is a legitimate business purpose or economic substance to the royalty-payment transactions. On cross-examination, Pomp acknowledged that states have other methods of preventing those deductions that lack a legitimate business purpose or economic substance, also known as "sham" deductions. Therefore, Pomp also conceded that add-back statutes are not limited to the prevention of sham deductions.

The Department presented the testimony of witnesses who spoke in support of the add-back statute. Dr. Alan Shapiro, a professor of finance at the University of Southern California, testified that add-back statutes attempt to "cure some of the distortions" that arise in separate-reporting states because of transactions between related corporations. Dr. Shapiro explained that Alabama operating companies add value to their products through the use of intangibles for which royalties are paid and that the add-back statute is an attempt to allocate some of that value or income to Alabama.

Peter Enrich, a law professor from Northeastern University who specializes in state and local taxation, testified that add-back statutes are not designed to address the issue of sham deductions. Enrich stated that he believed that unreasonableness exceptions to add-back statutes, such as the one in § 40-18-35(b)(2), are designed to avoid situations in which the

resultant tax on the corporation would be out of proportion to the corporation's activity in the taxing state.

Joe Garrett, the Department's administrator of tax policy, testified that in August 2003 the Department adopted a regulation ("the add-back regulation") that interprets the provisions of the add-back statute. *See* Rule 810-3-35-.02, Ala. Admin. Code (Department of Revenue). In essence, that regulation, in part, interprets the unreasonableness exception to apply when there is "no fair relation" to the corporate taxpayer's activities in Alabama. It is undisputed, however, that the add-back regulation does not apply to this case because it was adopted by the Department after this dispute arose.

Garrett's testimony indicated that on numerous occasions during the 14-month interim between the December 2001 enactment of the add-back statute and the August 2003 adoption of the add-back regulation, the Department had granted exceptions pursuant to § 40-18-35(b)(2). Garrett explained that the Department had granted exceptions both on the basis of the unreasonableness exception to the add-back statute and as an alternative adjustment by the commissioner. *See* § 40-18-35(b)(2). Garrett testified that a large number of taxpayers had sought to avoid the add-back statute by asserting that the unreasonableness exception set forth in subsection (b)(2) applied to the transactions at issue because of business purpose or economic substance and that the Department has denied those requests.

According to Garrett, the Department has applied the unreasonableness exception to those situations in which a corporation's tax as a result of the application of the add-back statute would be "out of propor-

tion with what could reasonably be said to be attributed to the State.” Garrett stated that the add-back regulation was formulated in response to questions concerning the interpretation of the add-back statute. Garrett testified that the provisions of the add-back regulation pertaining to the unreasonableness exception were consistent with the interpretation the Department had followed from the date the add-back statute was enacted. Garrett also stated that the adoption of the add-back regulation had not resulted in a change in the manner in which the Department had interpreted or applied the unreasonableness exception to the add-back statute.<sup>4</sup>

VFJ also presented expert testimony to support its claim that the subsection (b)(1) exception, known as the “subject-to-tax exception,” of the add-back statute exempted it from the statute’s application. That evidence is set forth in the section of this opinion addressing VFJ’s claim with regard to the subject-to-tax exception.

---

<sup>4</sup> Garrett testified, in part:

“[GARRETT:] Well, we—we told our people—our people meaning primarily our audit staff, people who reviewed returns—from early on, as soon as returns came in with the add-back issues on them, particularly with regard to the exceptions we’re talking about here today, what our interpretation was.

“THE COURT: Right.

“[GARRETT:] . . . . And at least with respect to the unreasonableness exception, that business purpose, economic substance, arm’s length pricing was not enough.

“THE COURT: Okay.

“[GARRETT:] And so we didn’t really –we didn’t have to go backward and do anything differently after the reg came about.”

### *Judgment*

In its judgment, the trial court concluded that the unreasonableness exception to the add-back statute contained at § 40-18-35(b)(2) applied, and, therefore, it reversed the Department's assessment. In concluding that the add-back statute did not apply because the unreasonableness exception disposed of the case, the trial court found it unnecessary to resolve VFJ's claim regarding the subject-to-tax exception found in § 40-18-35(b)(1) and VFJ's constitutional challenges to the add-back statute.<sup>5</sup> The Department timely appealed.

---

<sup>5</sup> We conclude that the trial court's judgment is final. The trial court disposed of the case based on one of the exceptions to the add-back statute claimed by VFJ; accordingly, it was unnecessary for it to address the other claimed exception. The trial court was not required to address the constitutional challenges VFJ had asserted, because, once the trial court had ruled in favor of VFJ on another basis, it was not necessary to reach the constitutional issues. Our supreme court has explained:

““A court has a duty to avoid constitutional questions unless *essential* to the proper disposition of the case.” *Lowe v. Fulford*, 442 So. 2d 29, 33 (Ala. 1983) (quoting trial court's order citing *Doughty v. Tarwater*, 261 Ala. 263, 73 So. 2d 540 (1954); *Moses v. Tarwater*, 257 Ala. 361, 58 So. 2d 757 (1952); and *Lee v. Maccn County Bd. of Educ.*, 231 F. Supp. 743 (M.D. Ala. 1964)). “Generally courts are reluctant to reach constitutional questions, and should not do so, if the merits of the case can be settled on non-constitutional grounds.” *Lowe*, 442 So. 2d at 33 (quoting trial court's order citing *White v. U.S. Pipe & Foundry Co.*, 646 F.2d 203 (5th Cir. 1981)). “No matter how much the parties may desire adjudication of important questions of constitutional law, broad considerations of the appropriate exercise of judicial power prevent[] such determinations unless actually compelled by the litigation before the court.” *Lowe*, 442 So. 2d at 33 (quoting trial court's order

As an initial matter, this court must resolve a conflict in the manner in which the parties interpret the trial court's judgment. In making its arguments to this court, the Department asserts that the trial court's judgment was based on a finding that the application of the add-back statute would be unreasonable because the royalty payments to the IMCOs had a business purpose and an economic substance. In contrast, VFJ contends that the trial court based its judgment on a determination that the application of the add-back statute would result in a distortion of VFJ's income attributable to Alabama.

In reaching its legal conclusions, the trial court stated, in pertinent part:

"Because add-back in VFJ's circumstances effectively denies it a deduction for a necessary cost of doing business in Alabama, thereby resulting in a calculation of taxable income that includes income fairly attributable to other states, add-back is unreasonable and thus not required for VFJ.

"States have rightfully been concerned about taxpayers taking advantage of IMCO structures by setting up 'shell' or 'sham' corporations in low-tax jurisdictions such as Delaware or Nevada or several other states and shifting substantial portions of their income to low-tax jurisdictions without any real business activity taking place in those other states. See, e.g., *Syms Corp. v. Commissioner of Revenue*, 436 Mass. 505, 765 N.E.2d 758 (Mass. 2002). In response to taxpayers generating large deductions from these sham or

---

citing *Troy State Univ. v. Dickey*, 402 F.2d 515 (5th Cir. 1968))."

*Chism v. Jefferson County*, 954 So. 2d 1058, 1063 (Ala. 2006).

shell corporations, several states passed statutes intended to deny taxpayers tax benefits from these sham corporations. Alabama's add-back statute is one of these statutes.

"Lee and Wrangler, however, are not sham or shell corporations. There were several business purposes for their creation and continued viability. They carry on substantial activities that are vital to the business operations of the VF group. VFJ had a business purpose for making the royalty payments—it needed the use of these valuable trademarks in its operations. The payments also had economic substance—they were made in cash and conferred on VFJ the right to use the trademarks.

"Deductions for the cost of doing business are an essential part of any tax on net income. Recognizing this, Alabama has long allowed deductions for 'the expenses of carrying on such business.' Subdivision 5, § 454, Code of Alabama (1886). Alabama encourages such deductions for ordinary and necessary business expenses, '[t]he theory being, presumably, that the spending of money to make money should be encouraged to the end that taxes will be paid on the net accomplished.' *Boswell v. Bonham*, 53 Ala. App. 54, 297 So. 2d 379 (Ala. Civ. App. 1974).

"An expense is an 'ordinary' business expense when it is normal, common, and accepted under the circumstances by the business community. *Welch v. Helvering*, 290 U.S. 111, 113-115, 54 S. Ct. 8, 78 L. Ed. 212, 1933-2 C.B. 112 (1933). The testimony revealed that payment of royalties to IMCOs (both related and non-related) is normal, common, and accepted in the business commu-

nity. An expense is a necessary business expense when it is 'appropriate and helpful' in developing the taxpayer's business. *Welch v. Helvering*, 290 U.S. [at] 113 . . . (also noting that courts 'should be slow to override [the taxpayer's] judgment' as to whether an expense is 'necessary'). The royalty payments made by VFJ in 2001 were thus ordinary and necessary in its business, giving VFJ the right to manufacture jeanswear with the valuable Lee and Wrangler trademarks.

"Unreasonable' is not defined in the statute; it thus should be interpreted in accordance with the legislature's intent in enacting the statute. *State Dep't of Revenue v. Amerada Hess Corp*, 788 So. 2d 179 (Ala. Civ. App. 2000). Since the purposes of the add-back statute are to prevent abusive deductions and to ensure that income fairly attributable to Alabama is taxed in Alabama, it is unreasonable to require add-back when these purposes would be frustrated by add-back. Add-back is unreasonable in VFJ's case because VFJ's royalty payments are not abusive—they have economic substance and business purpose—and represent real and necessary costs of doing business in Alabama, and to disallow these deductions would distort the amount of VFJ's income fairly attributable to this state.

"Accordingly, considering the language and purpose of the add-back statute, Alabama public policy allowing deductions for business expenses in determining net income, and the particular facts of this case, I find that it would be 'unreasonable' to require add-back to VFJ's royalty payments."

(Emphasis added.)

After reviewing the legal conclusions in the trial court's judgment, we agree with the Department's characterization of the nature of the trial court's determination with regard to the unreasonableness exception to the add-back statute. The trial court's judgment sets forth a finding that VFJ's income would be distorted by the application of the add-back statute. However, the language of the judgment indicates that the trial court interpreted the unreasonableness exception as being largely dependent on whether there is business purpose or economic substance to the royalty-payment transactions. Specifically, the judgment indicates that the trial court concluded that so long as a plausible business purpose for the royalty payments exists or the royalty deductions are not abusive, any refusal to allow the deduction for those royalty payments would result in a distortion of VFJ's income attributable to Alabama.

As further support for this conclusion, it should be noted that other than some very general testimony, VFJ presented no evidence tending to support a finding that the application of the add-back statute would distort its income attributable to Alabama. VFJ has asserted generally that disallowing the deduction for royalty payments to a related member distorts its income by not allowing it to deduct that expense as an ordinary and necessary cost of doing business in Alabama. As discussed later in this opinion, however, states may fashion their own income-tax formulas and are not required to grant all the deductions allowed by the federal taxing scheme. VFJ did not challenge the Department's calculation of the amount of income to be added back under § 40-18-35(b), nor did it present any evidence tending to support a conclusion that the amount of tax resulting from the application of the add-back statute would

result in its paying an amount of tax disproportionate to its presence and operations in Alabama. Thus, the trial court's finding that the application to VFJ of the add-back statute would "distort the amount of VFJ's income fairly attributable to this state" is based upon its interpretation of the general effect of the application of the add-back statute. We next address the arguments presented by the parties with regard to the unreasonableness exception of the add-back statute, which exception is set forth at § 40-18-35(b)(2), Ala. Code 1975.

### *The Unreasonableness Exception*

The Department raises several arguments on appeal to support its contention that the trial court erred in interpreting the unreasonableness exception to Alabama's add-back statute. It contends that the trial court's interpretation of the unreasonableness exception found in § 40-18-35(b)(2) effectively nullifies another exception to the add-back statute, specifically the exception contained in subsection (b)(3). The Department also contends that the trial court's interpretation of the unreasonableness exception renders the add-back statute itself ineffective by giving it no field of operation, or, phrased another way, that the trial court's interpretation allows the exception to "swallow the add-back rule."

As mentioned earlier in this opinion, the unreasonableness exception to the add-back statute provides, in pertinent part, that the costs or expenses related to intangibles owned by related-member corporations are to be added back into the calculation of taxable income "unless the corporation establishes that the adjustments are unreasonable . . . ." § 40-18-35(b)(2). The term "unreasonable" is not defined in the article governing income taxation contained in

the Alabama Code. Our general rule of statutory interpretation is that the commonly accepted definition of a term should be used when the legislature enacts legislation that fails to define the term therein. Our supreme court has explained:

"It is this Court's responsibility to give effect to the legislative intent whenever that intent is manifested. *State v. Union Tank Car Co.*, 281 Ala. 246, 248, 201 So. 2d 402, 403 (1967). When interpreting a statute, this Court must read the statute as a whole because statutory language depends on context; we will presume that the Legislature knew the meaning of the words it used when it enacted the statute. *Ex parte Jackson*, 614 So. 2d 405, 406-07 (Ala. 1993). Additionally, when a term is not defined in a statute, the commonly accepted definition of the term should be applied. *Republic Steel Corp. v. Horn*, 268 Ala. 279, 281, 105 So. 2d 446, 447 (1958). Furthermore, we must give the words in a statute their plain, ordinary, and commonly understood meaning, and where plain language is used we must interpret it to mean exactly what it says. *Ex parte Shelby County Health Care Auth.*, 850 So. 2d 332 (Ala. 2002)."

*Bean Dredging, L.L.C. v. Alabama Dep't of Revenue*, 855 So. 2d 513, 517 (Ala. 2003).

The term "unreasonable" has been defined as "[n]ot guided by reason; irrational or capricious," see *Black's Law Dictionary* 1574 (8th ed. 2004), and as "not governed by or acting according to reason" or "exceeding the bounds of reason or moderation," *Merriam-Webster's Collegiate Dictionary* 1371 (11th ed. 2003).

The add-back regulation has established guidelines for determining whether the "unreasonableness" exception applies. In essence, that regulation specifies that the application of the add-back statute will be deemed "unreasonable" when the tax resulting from the application of the statute has no "fair relation" to or is out of proportion to the corporation's activities in Alabama.<sup>6</sup> The add-back regulation does not apply to this case because it was not in effect at the time this dispute arose. However, the fact that the add-back regulation does not apply does not mean that we should disregard the Department's interpretation of the provisions of the add-back statute during the period between the enactment of the add-back statute and the adoption of the add-back regulation.

The Department's interpretation of the add-back statute is entitled to deference. See *Farmer v. Hypo Holdings, Inc.*, 675 So. 2d 387, 390 (Ala. 1996) ("[A]n interpretation placed on a statute by an adminis-

---

<sup>6</sup> With regard to the unreasonableness exception to Alabama's add-back statute, the add-back regulation specifies:

"(h) The [add-back statute] will be considered unreasonable if:

- "1. The taxpayer establishes that, based on the entirety of the taxpayer's particular facts and circumstances, the adjustments have increased the taxpayer's Alabama income tax liability to an amount that bears no fair relation to the taxpayer's Alabama presence, or
- "2. The taxpayer establishes that the interest or intangible expense was paid to a related member that passed through the interest or intangible payment via a corresponding interest or intangible expense payment to an unrelated third party. . . ."

Rule 810-3-35-.02(3)(h), Ala. Admin. Code (Department of Revenue).

trative agency charged with its enforcement will be given great weight and deference by a reviewing court.”). The deference to be afforded the Department’s interpretation of the add-back statute is based on the Department’s expertise in the area of taxation. *Hamrick v. Alabama Alcoholic Beverage Control Bd.*, 628 So. 2d 632, 633 (Ala. Civ. App. 1993). “[W]hen the highest administrative officials charged with the duty of administering the tax laws have construed a tax statute, their construction should be given favorable consideration.” *Bean Dredging, L.L.C. v. Alabama Dep’t of Revenue*, 855 So. 2d at 517.

“[I]t is well established that in interpreting a statute, a court accepts an administrative interpretation of the statute by the agency charged with its administration, if that interpretation is reasonable. *Ex parte State Dep’t of Revenue*, [683 So. 2d 980 (Ala. 1996)] (citing *Alabama Metallurgical Corp. v. Alabama Pub. Serv. Comm’n*, 441 So. 2d 565 (Ala. 1983)). Absent a compelling reason not to do so, a court will give great weight to an agency’s interpretations of a statute and will consider them persuasive. *Ex parte State Dep’t of Revenue*, *supra* (citing *Moody v. Ingram*, 361 So. 2d 513 (Ala. 1978)).”

*State v. Pettaway*, 794 So. 2d 1153, 1157 (Ala. Civ. App. 2001).

The undisputed evidence presented by the Department indicates that the Department had previously interpreted the “unreasonableness” exception in the manner now set forth in the add-back regulation. Garrett’s testimony indicated that even before the adoption of the add-back regulation, the Department had consistently interpreted the unreasonableness

exception as applying when the resulting tax would be "out of proportion" to the corporation's presence in Alabama. He further testified that on many occasions before the adoption of the add-back regulation, the Department, in evaluating a taxpayer corporation's claim that the add-back statute was unreasonable under subsection (b)(2), had refused to consider whether the transactions paid to a related company had a legitimate business purpose or economic substance. Thus, the Department has consistently interpreted the unreasonableness exception as not being determined by business purpose or economic substance. Further, the foregoing demonstrates that the interpretation of the unreasonableness exception the Department implemented even before the adoption of the add-back regulation is consistent with the commonly accepted definition of the term "unreasonable," i.e., exceeding reasonable limits or clearly excessive. *See Bean Dredging, L.L.C. v. Alabama Dep't of Revenue*, supra. The remainder of the Department's arguments with regard to the unreasonableness exception strengthen the presumption in favor of its interpretation of that exception.

The Department argues that to interpret the unreasonableness exception as based almost exclusively on a determination of whether transactions pertaining to intangibles between related companies have a business purpose or economic substance would provide the add-back statute with little, if any, field of operation other than to disallow sham deductions. The Department insists that the add-back statute was not enacted in order to address the problem of deductions based on sham transactions, i.e., those transactions that lack a legitimate business purpose or economic substance. The evidence presented at trial referenced on several occasions an example of a

classic sham royalty-payment transaction. In that situation, a parent company creates a corporation to which royalty payments or licensing fees are paid. The sham corporation has no employees or business office; its sole function is to receive licensing fees or royalty payments from a related member. Because the sham corporation is located in a state in which that royalty income would not be subject to corporate income tax, the payments escape state taxation.

The parties did not dispute that both before and after the enactment of the add-back statute, Alabama could, without resorting to the add-back statute, investigate and refuse to grant deductions such as those just described on the basis that payments made to sham corporations did not have a legitimate business purpose or economic substance. As indicated earlier, the starting point for determining a corporation's taxable income in Alabama is the amount of federal taxable income. Under the Internal Revenue Code, a deduction is allowed for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." 26 U.S.C. § 162(a). Alabama can challenge a sham deduction as being not "ordinary and necessary" under 26 U.S.C. § 162. See § 40-18-33, Ala. Code 1975 ("In the case of a corporation . . . , the term 'taxable income' means federal taxable income without the benefit of federal net operating losses plus the additions prescribed and less the deductions and adjustments allowed by this chapter and as allocated and apportioned to Alabama."); see also *Baisch v. Department of Revenue*, 316 Ore. 203, 850 P.2d 1109 (1993). The parties do not dispute the Department's power to contest sham transactions in this manner, and at trial, all the witnesses who were asked about this matter confirmed that Alabama has the power to

challenge sham transactions without reference to the add-back statute.

Given the foregoing, it seems unlikely that the legislature intended the add-back statute to address the problem of sham transactions, a problem that may be addressed in the absence of an add-back statute. It also seems unlikely that in enacting the add-back statute the Alabama Legislature was attempting to create a new method by which it could challenge sham transactions. Rather, the courts should assume that in enacting the add-back statute the legislature had in mind a different purpose and field of operation.

“This court notes that a statute is presumed to have been enacted with a meaningful purpose. *Adams v. Mathis*, 350 So. 2d 381, 385-86 (Ala. 1977). “The legislature will not be presumed to have done a futile thing in enacting a statute.” *Ex parte Watley*, 708 So. 2d 890, 892 (Ala. 1997).”

*Board of School Comm’rs of Mobile County v. Biggs*, 939 So. 2d 942, 945 (Ala. Civ. App. 2006) (quoting *State v. Pettaway*, 794 So. 2d at 1156).

The title to Act No. 2001-1088, which, in part, created the add-back statute, indicates that the legislature intended, among other things, to “disallow deductions for certain payments for intangible property (patents and copyright) and interest expense to related entities” and “to waive certain interest and penalties . . . and the add back of *certain* interest and intangible expenses.” That statement of legislative purpose does not mention any intent to address the issue of sham or fraudulent transactions or deductions.

Rather, in enacting the add-back statute, the legislature evidenced its intent to eliminate, subject to certain exceptions, one type of deduction for ordinary and necessary business exceptions. A state, subject to constitutional limitations, may fashion its own taxing scheme. In doing so, a state is not required to use the same deductions the federal-taxation scheme allows. "[A] statutory tax deduction or exemption is a matter of legislative grace." *Ex parte State Dep't of Revenue*, 441 So. 2d 598, 601 (Ala. 1983). In enacting the add-back statute, the Alabama Legislature elected not to extend its "grace" to deductions for transactions between related entities involving royalty payments for intangible assets. Under the general rules of statutory interpretation, which provide that a statute is presumed to have a meaningful purpose, we conclude that Alabama's add-back statute was intended to have the purpose set forth by the legislature in Act No. 2001-1088. Such an interpretation affords the add-back statute both a meaningful purpose and a field of operation.

Each of the exceptions to the add-back statute should also be interpreted as having a meaningful purpose and effect. "There is a presumption that every word, sentence, or provision [of a statute] was intended for some useful purpose, has some force and effect, and that some effect is to be given to each, and also that no superfluous words or provisions were used." *Ex parte Uniroyal Tire Co.*, 779 So. 2d 227, 236 (Ala. 2000) (quoting *Sheffield v. State*, 708 So. 2d 899, 909 (Ala. Crim. App. 1997)).

Section 40-18-35(b)(3) provides an exception when the corporation can establish, first, that the payments to the related-member IMCO did not have as their primary purpose the avoidance of state taxa-

tion, *and*, second, that the related member to whom the payment was made was not engaged primarily in managing intangible assets. The § 40-18-35(b)(3) exception specifies that a transaction will be presumed not to have tax avoidance as its primary purpose if the transaction has a substantial business purpose or economic substance. *See* § 40-18-35(b)(3), Ala. Code 1975. However, in order for the existence of a business purpose or economic substance to be relevant, there must also be a showing that the related entity to which the transaction is paid does not have the management of intangible assets as its primary business purpose. § 40-18-35(b)(3).

In this case, VFJ did not seek an exception from the add-back statute under subsection (b)(3). Lee and Wrangler, the related members to whom VFJ made its royalty payments, are undisputedly engaged primarily in managing intangible assets, as specified in § 40-18-35(b)(3), so that subsection could not apply to the facts of this case. However, the trial court seems to have focused on the first part of the subsection (b)(3) exception in determining that the application of the add-back statute in this case was unreasonable because the royalty-payment transactions had a substantial business purpose or economic substance. Interpreting the unreasonableness exception of subsection (b)(2) in that manner, however, nullifies the effect of the subsection (b)(3) exception by eliminating the need for that exception. As the Department points out, the trial court's interpretation "would ensure that the [unreasonableness exception in § 40-18-35(b)(2) would] apply in every case in which the (b)(3) exception might apply." In other words, to construe the unreasonableness exception in subsection (b)(2) as requiring only a showing of a business purpose or economic substance would effectively render ineffec-

tive the exception set forth in § 40-18-35(b)(3), which requires a similar showing *as well as* a showing that the related company to whom the payment is made does not manage an intangible asset. We must presume that the legislature did not, in enacting subsection (b)(3), create a redundant exception to the add-back statute. *Ex parte Uniroyal Tire Co.*, *supra* (it must be presumed the legislature did not intend to enact a superfluous provision).

The rules of statutory construction require that each statute or part thereof be given effect when possible. *Ex parte Uniroyal Tire Co.*, *supra*. Accordingly, in order for the unreasonableness exception to have its own effect or field of operation that is not duplicative of the subsection (b)(3) exception, the unreasonableness exception must be interpreted not to focus on a showing of business purpose or economic substance.

The Department has interpreted the unreasonableness exception as being concerned with whether the add-back statute results in taxation that is out of proportion to the corporation's activities in Alabama. That interpretation, which was later formalized in the add-back regulation, is consistent with the common-usage definitions of the term "unreasonable" as "irrational," "capricious," or "exceeding the bounds of reason or moderation." *Black's Law Dictionary* 1574; *Merriam-Webster's Collegiate Dictionary* 1371. "Absent a compelling reason not to do so, a court will give great weight to an agency's interpretations of a statute and will consider them persuasive." *State v. Pettaway*, 794 So. 2d at 1157 (citing *Ex parte State Dep't of Revenue*, 683 So. 2d 980 (Ala. 1996), citing in turn *Moody v. Ingram*, 361 So. 2d 513 (Ala. 1978)). VFJ has presented no "compelling reason" that leads

this court to disagree with the arguments submitted by the Department or its interpretation of the unreasonableness exception to the add-back statute. Accordingly, we hold that the Department's interpretation of the unreasonableness exception is appropriate and is the correct interpretation that should govern the disposition of this matter.

The parties have disputed only the interpretation of the add-back statute. They did not present any evidence regarding whether the facts of this case justify the application of the subsection (b)(2) exception to the add-back statute. There is no specific evidence showing a possible distortion of VFJ's income if the add-back statute is applied, and there is no evidence indicating that the amount of tax to which VFJ is subject under the add-back statute is out of proportion to VFJ's activities in Alabama. In other words, the record does not demonstrate that the application of the add-back statute to VFJ for the tax year in question was unreasonable under the proper interpretation of the exception in subsection (b)(2) of the statute. Given the arguments and evidence presented, we must reverse that part of the trial court's judgment that concluded that the application of the add-back statute to VFJ was unreasonable under § 40-18-35(b)(2).

It is well settled that an appellate court may affirm a judgment if the judgment is correct for any reason, even one not argued. *Tucker v. Nichols*, 431 So. 2d 1263, 1264-65 (Ala. 1983); see also *Bay Lines, Inc. v. Stoughton Trailers, Inc.*, 538 So. 2d 1013, 1017 (Ala. 2002); *Boykin v. Magnolia Bay, Inc.*, 570 So. 2d 639, 642 (Ala. 1990); *Bennett v. Bennett*, 454 So. 2d 535, 538 (Ala. 1984); and *Upchurch v. Universal Underwriters Ins. Co.*, 610 So. 2d 1163, 1167 (Ala. Civ.

App. 1992). Accordingly, we next consider whether the trial court's judgment in favor of VFJ may be affirmed on the basis of VFJ's alternate claim that the exception found in § 40-18-35(b)(1), Ala. Code 1975, exempts it from the application of the add-back statute. *See Steele v. Walser*, 880 So. 2d 1123 (Ala. 2003) (noting the rule that an appellate court may affirm a judgment based on an issue that is rejected by the trial court by considering an alternative argument asserted by the appellee).

### *The Subject-to-Tax Exception*

VFJ argued at trial that the subject-to-tax exception found in subsection (b)(1) of the add-back statute precluded the Department from imposing its assessment. We reiterate the specific language of the subsection (b)(1) exception:

"(1) For purposes of computing its taxable income, a corporation shall add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions, with one or more related members, except to the extent the corporation shows, upon request by the commissioner, that the corresponding item of income was in the same taxable year: a. Subject to a tax based on or measured by the related member's net income in Alabama or any other state of the United States, or b. subject to a tax based on or measured by the related member's net income by a foreign nation which has in force an income tax treaty with the United States, if the recipient was a 'resident' (as defined in the income tax treaty) of the foreign nation. For purposes of this section, 'subject to a tax

based on or measured by the related member's net income' means that the receipt of the payment by the recipient related member is reported and included in income for purposes of a tax on net income, and not offset or eliminated in a combined or consolidated return which includes the payor."

§ 40-18-35(b)(1).

VFJ filed a corporate income-tax return in North Carolina, a separate-reporting state, for the tax year in question. For reasons not fully explained in the record, Lee and Wrangler also filed corporate income-tax returns in North Carolina, although each IMCO filed that return "under protest." Joseph McGraw, VF's manager of state taxes, opined that Lee and Wrangler did not have a sufficient nexus with North Carolina to require those IMCOs to pay corporate income tax in that state. The testimony at trial showed that the IMCOs may have filed the returns in North Carolina in order to benefit VFJ and other VF subsidiaries. Pursuant to North Carolina's add-back statute, VFJ and other VF subsidiaries with activity in North Carolina would not have to add back the royalty payments they made to the IMCOs if the IMCOs also filed corporate income-tax returns in North Carolina. See N.C. Gen. Stat. § 105-130.7A(c).

In calculating taxable income in North Carolina, each IMCO listed its federal taxable income on its North Carolina corporate tax return. Lee reported federal taxable income of \$ 73,021,142, and Wrangler reported \$ 69,644,967 in federal taxable income. Each IMCO applied its apportionment factor to determine the amount of income attributable or apportionable to North Carolina. Therefore, neither IMCO paid North Carolina state income taxes on the

full amount of its federal taxable income. For the 2001 tax year, Lee's apportionment factor for North Carolina was 2.8783%, and Lee paid \$ 143,480 in North Carolina corporate income tax. For the 2001 tax year, Wrangler's apportionment factor for North Carolina was 3.9415%, and it paid \$ 190,155 in corporate income tax in that state.

With regard to the specific facts of this case, the subject-to-tax exception applies if Lee and Wrangler (the "related members" under the subject-to-tax exception) "reported and included" the royalty payments from VFJ (the taxpayer corporation) "for purposes of a tax on net income" in another state (in this case, North Carolina). *See* § 40-18-35(b)(1), Ala. Code 1975. The parties dispute the proper interpretation of the "reported and included" language of the subject-to-tax exception.

VFJ argues that the subject-to-tax exception should be interpreted to mean that the entire amount of federal taxable income the IMCOs listed on their respective North Carolina corporate income-tax returns was "subject to tax," even if only a small part of that was actually apportioned to North Carolina and taxed in that state. According to VFJ, the entire amount of federal taxable income for each of the IMCOs was both "reported" and "included," as those terms are used in § 40-18-35(b)(1), on their respective North Carolina corporate income-tax returns. Thus, according to VFJ's argument, all the IMCOs' income was "subject to tax," and the subsection (b)(1) exception applies and prohibits this state from adding back into the calculation of its taxable income any of the royalty payments it made to the IMCOs.

The Department, on the other hand, argues that the subject-to-tax exception excludes from the appli-

cation of Alabama's add-back statute only that income the IMCOs apportioned to North Carolina. In other words, the Department argues that only 2.8783% of Lee's income and 3.9415% of Wrangler's income, the amounts those IMCOs apportioned to North Carolina, should be considered "subject to tax" in that state. According to the Department, the remainder of the IMCOs' income, i.e., that income not apportioned to North Carolina, is not "reported and included" as that term is used in the subject-to-tax exception to Alabama's add-back statute. Under the Department's interpretation, even considering the subject-to-tax exception, the Department could add back the royalty payments to VFJ's federal taxable income and apply the Alabama apportionment factor to that part of VFJ's income that was not apportioned to North Carolina. In other words, the Department argues that the subject-to-tax exception should apply only on what is known as a "post-apportionment" basis, and VFJ contends that the subject-to-tax exception should be applied on a "pre-apportionment" basis.

Professor Pomp's testimony concerning the subject-to-tax exception supported the interpretation advanced by VFJ. Pomp testified that any income that is listed on an income-tax return should be subject to a tax, regardless of whether an apportionment factor would result in only a minimal taxation of the related member for a large amount of reported federal taxable income.

Professor Enrich testified that a number of states that have add-back statutes do not have a subject-to-tax exception because an add-back statute itself requires only that income that can be properly apportioned to that state be included in calculating taxable

income. In Enrich's opinion, the logical reason for some states' inclusion in their add-back statutes of a subject-to-tax exception is "really nothing more than an abundance of caution." Enrich also stated that the Department's interpretation achieves a reasonable result, given that the purpose of an add-back statute is to ensure that income is taxed in some state.<sup>7</sup> Further, Enrich pointed out that to interpret the subject-to-tax exception in the manner advocated by VFJ would render the add-back statute practically meaningless because it would be relatively simple for a corporation to find a way in which to pay a minimal amount of state tax in one state for the specific purpose of avoiding taxation in states with subject-to-tax exceptions in their add-back statutes.

Richard Henninger, the director of individual and corporate income tax for the Department, testified that during the interim between the enactment of the add-back statute and the adoption of the add-back regulation, the Department had always applied the subject-to-tax exception on a post-apportionment basis. Joe Garrett, the administrator for tax policy for

---

<sup>7</sup> Professor Enrich explained:

"The ambition of the add-back statute is to make sure that all of the income is subject to tax somewhere, that it's all apportioned out and that each state is able to tax or not tax as it chooses the share that is attributed to it.

"If the statute were read to say, well, if some one state to which some, perhaps quite small, portion of the income is attributable, if that state taxes it, then nobody else can—or we can't attribute our fair share to us would be a non-sensical reading of the statute, whereas to say, well, to the extent that one state does tax some, we'll just apportion the rest, is going to achieve the statutory purpose of making sure that all the income is attributed to some place that can choose whether to tax it or not."

the Department, also testified that the Department had consistently applied the subject-to-tax exception on a post-apportionment basis.

The add-back regulation, adopted after this dispute arose, interprets the definition of "subject to a tax" as referring to income that is "reported and included in *post-allocation and apportionment income* for purposes of a tax applied to the net income apportioned or allocated to the taxing jurisdiction." Rule 810-3-35-.02(3)(f), Ala. Admin. Code (Department of Revenue). The evidence presented at trial indicates that, similar to the Department's interpretation of the unreasonableness exception, the Department has consistently interpreted the subject-to-tax exception in the manner eventually adopted in the add-back regulation and that there was no change in the Department's actions with regard to the subject-to-tax exception when the add-back regulation was ultimately adopted. Thus, since the enactment of the add-back statute, the Department's interpretation of the subject-to-tax exception has been consistent. As stated earlier in this opinion, the interpretation of the add-back statute by the Department, the agency charged with the enforcement of the statute, is entitled to deference. *Bean Dredging, L.L.C. v. Alabama Dep't of Revenue*, *supra*; *Farmer v. Hypo Holdings, Inc.*, *supra*; and *Hamrick v. Alabama Alcoholic Beverage Control Bd.*, *supra*.

The research conducted by the parties and by this court has failed to uncover any caselaw that has addressed the application of an exception similar to the one at issue here. Therefore, we must turn to the specific language of the subsection (b)(1) exception and apply the general rules of statutory construction in interpreting that exception.

“The fundamental rule of statutory construction is to ascertain and give effect to the intent of the legislature in enacting the statute.” *IMED Corp. v. Systems Eng’g Assocs. Corp.*, 602 So. 2d 344, 346 (Ala. 1992). Where possible, the legislature’s intent in enacting the statute should be discerned from the language of the statute. *Perry v. City of Birmingham*, 906 So. 2d 174, 176 (Ala. 2005). Further, “[i]f the statute is ambiguous or uncertain, the court may consider conditions which might arise under the provisions of the statute and examine results that will flow from giving the language in question one particular meaning. . . .”

“In deciding between alternative meanings . . . , we will not only consider the results that flow from assigning one meaning over another, but will also presume that the legislature intended a rational result, one that advances the legislative purpose in adopting the legislation, that is “workable and fair,” and that is consistent with related statutory provisions.”

*Ex parte Berryhill*, 801 So. 2d 7, 10 (Ala. 2001) (quoting *John Deere Co. v. Gamble*, 523 So. 2d 95, 100 (Ala. 1988)).

The language of the subsection (b)(1) exception specifies that the add-back statute does not apply “to the extent the corporation shows . . . that the corresponding item of income was . . . [s]ubject to a tax based on or measured by the related member’s net income in Alabama or any other state of the United States.” § 40-18-35(b)(1) (emphasis added). The subject-to-tax exception goes on to define “subject to a tax based on or measured by the related member’s net income” as meaning “that the receipt of the payment by the recipient related member is *reported and*

*included in income for purposes of a tax on net income, and not offset or eliminated in a combined or consolidated return which includes the payor." Id. (emphasis added).*

Thus, the legislature specified that for items of income to be "subject to . . . tax," they must be both "reported *and* included in income for purposes of a tax on net income." § 40-18-35(b)(1) (emphasis added). Therefore, this court must assume that the legislature intended that the terms "reported" and "included" have different meanings. The courts must presume that in enacting the add-back statute, the legislature intended that each word of the statute have effect, and we must also presume that the legislature did not include meaningless language or redundancies in the statute. *Ex parte Children's Hosp. of Alabama*, 721 So. 2d 184, 190-91 (Ala. 1998); *see also Board of School Comm'rs of Mobile County v. Biggs*, *supra*. Accordingly, under the subsection (b)(1) exception to the add-back statute, the items of income are to be reported by the corporation for which those payments constitute income, and that income must be "included in income for the purposes of a tax on net income."

We hold that for the purposes of the subject-to-tax exception, the term "included in income for the purposes of a tax on net income" means that the income at issue is actually taxed as a part of a tax on net income. Stated another way, we interpret the subject-to-tax exception set forth in subsection (b)(1) of Alabama's add-back statute to apply on a post-apportionment, rather than on a pre-apportionment, basis.

We believe that this holding is consistent with the intention of the legislature in enacting the add-back statute and that it advances the purpose of the leg-

islature in enacting the add-back statute. See *Ex parte Berryhill*, supra; *John Deere Co. v. Gamble*, supra. As Professor Enrich pointed out in his testimony, interpreting the subject-to-tax exception to apply on a pre-apportionment basis would effectively negate the operation of the add-back statute. Under a pre-apportionment interpretation, a corporation could easily avoid the application of an add-back statute that contains a subject-to-tax exception by paying corporate income tax in a state in which its apportionment factor is relatively insignificant. This case is an example of that possibility. Although each IMCO reported significant federal taxable income, Lee had a state-tax burden in North Carolina of approximately .0019% of its federal taxable income, and Wrangler paid state tax of approximately .0027% of its federal taxable income.<sup>8</sup> Based on its argument that that modest level of taxation met the requirements of the subsection (b)(1) exception to Alabama's add-back statute, VFJ sought to avoid the application of that statute.

An interpretation of the subject-to-tax exception that, in most cases, would result in a taxpayer's ability to avoid the application of the add-back statute would be "unreasonable, and, consequently, [it cannot] be considered to be the intent of the legislature." *John Deere Co. v. Gamble*, 523 So. 2d at 100. Such an interpretation would also serve to place Alabama back in the position it was in before the enactment of the add-back statute. "The legislature surely did not intend such a nonsensical result." *Ex parte State Dep't of Revenue*, 441 So. 2d at 604. We will presume

---

<sup>8</sup> Lee reported \$ 73,021,142 in 2001 in federal taxable income, and it paid \$ 143,480 for state taxes in North Carolina. Wrangler reported \$ 69,644,967 in 2001 in federal taxable income, and it paid \$ 190,155 for state taxes in North Carolina.

that the legislature “intended a rational result.” *Ex parte Berryhill*, 801 So. 2d at 10 (quoting *John Deere Co. v. Gamble*, 523 So. 2d at 100). Because we conclude that the trial court erred in its interpretation of the unreasonableness exception in entering a judgment in favor of VFJ, and because we cannot affirm the trial court’s judgment on the basis of the subject-to-tax exception, we reverse the trial court’s judgment. See *Steele v. Walser*, supra; see also *Fidelity Nat’l Title Ins. Co. of Tennessee v. Jericho Mgmt. Inc.*, 722 So. 2d 740, 743-44 (Ala. 1998) (declining to affirm a trial court’s order based on other arguments asserted by the appellee); *Mutual Assurance, Inc. v. Wilson*, 716 So. 2d 1160, 1165 (Ala. 1998) (same).

### *Constitutionality*

This court has rejected the other bases VFJ has advanced in support of the trial court’s judgment in its favor. Therefore, because the case cannot ““be settled on non-constitutional grounds,”” see *Chism v. Jefferson County*, 954 So. 2d 1058, 1063 (Ala. 2006) (quoting *Lowe v. Fulford*, 442 So. 2d 29, 33 (Ala. 1983)), we will consider VFJ’s constitutional challenges to the add-back statute.

““In reviewing [a question regarding] the constitutionality of a statute, we ‘approach the question with every presumption and intendment in favor of its validity, and seek to sustain rather than strike down the enactment of a coordinate branch of the government.’” *Moore v. Mobile Infirmary Ass’n*, 592 So. 2d 156, 159 (Ala. 1991) (quoting *Alabama State Fed’n of Labor v. McAdory*, 246 Ala. 1, 9, 18 So. 2d 810, 815 (1944)). Moreover, “[w]here the validity of a statute is assailed and there are two possible interpretations, by one of which the statute would be unconstitutional and by the other would be valid, the courts should

adopt the construction [that] would uphold it.” *McAdory*, 246 Ala. at 10, 18 So. 2d at 815. In *McAdory*, this Court further stated:

““[I]n passing upon the constitutionality of a legislative act, the courts uniformly approach the question with every presumption and intentment in favor of its validity, and seek to sustain rather than strike down the enactment of a coordinate branch of the government. All these principles are embraced in the simple statement that it is the recognized duty of the court to sustain the act unless it is clear beyond reasonable doubt that it is violative of the fundamental law.”

“246 Ala. at 9, 18 So. 2d at 815 (citation omitted). We must afford the Legislature the highest degree of deference, and construe its acts as constitutional if their language so permits. *Id.*”

*Kirby v. State*, 899 So. 2d 968, 972-73 (Ala. 2004) (quoting *Monroe v. Harco, Inc.*, 762 So. 2d 828, 831 (Ala. 2000)).

In the trial court, VFJ alleged that the add-back statute violates both the Due Process Clause and the Commerce Clause of the United States Constitution. Although on appeal VFJ purports to challenge the statute only on the basis that it violates the Commerce Clause, we note that at least one part of its argument on the issue of constitutionality intertwines with concepts that are related to both the Commerce Clause and the Due Process Clause. The United States Supreme Court has stated:

“Article I, § 8, cl. 3 [the Commerce Clause], of the Constitution expressly authorizes Congress to ‘regulate Commerce with foreign Nations, and among the several States.’ It says nothing about

the protection of interstate commerce in the absence of any action by Congress. Nevertheless, as Justice Johnson suggested in his concurring opinion in *Gibbons v. Ogden*, 22 U.S. 1, 9 Wheat 1, 231-232, 239, 6 L. Ed. 23 (1824), the Commerce Clause is more than an affirmative grant of power; it has a negative sweep as well. The Clause, in Justice Stone's phrasing, 'by its own force' prohibits certain state actions that interfere with interstate commerce. *South Carolina State Highway Dept. v. Barnwell Brothers, Inc.*, 303 U.S. 177, 185, 58 S. Ct. 510, 82 L. Ed. 734 (1938)."

*Quill Corp. v. North Dakota*, 504 U.S. 298, 309, 112 S. Ct. 1904, 119 L. Ed. 2d 91 (1992). The "negative sweep" of the Commerce Clause referenced above, known as "the dormant Commerce Clause," has been interpreted by the United States Supreme Court as prohibiting a state from imposing taxation on income that is not attributable to that state. *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 179-80, 115 S. Ct. 1331, 131 L. Ed. 2d 261 (1995); *Quill Corp. v. North Dakota*, *supra*.

The United States Supreme Court has established precedent for determining the constitutionality of a state-imposed tax on entities or activities that involve interstate commerce. In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 97 S. Ct. 1076, 51 L. Ed. 2d 326 (1977), the State of Mississippi imposed a tax on motor vehicles manufactured outside that state. The Supreme Court upheld the tax. In doing so, the Court rejected its prior decisions that held that a state could not tax income from activities that were part of interstate commerce. *See, e.g., Spector Motor Serv. v. O'Connor*, 340 U.S. 602, 71 S. Ct. 508, 95 L. Ed. 573

(1951), and *Freeman v. Hewit*, 329 U.S. 249, 67 S. Ct. 274, 91 L. Ed. 265 (1946). Instead, the Court relied on other decisions that held that the Commerce Clause was not designed to relieve those engaged in interstate commerce from the burden of state taxation but was instead intended to allow a state to impose taxation only on the state's fair share of the income derived from interstate activity. See, e.g., *General Motors Corp. v. Washington*, 377 U.S. 436, 84 S. Ct. 1564, 12 L. Ed. 2d 430 (1964), and *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 58 S. Ct. 546, 82 L. Ed. 823 (1938). In reaching its holding, the Supreme Court adopted language from cases in which it

“considered not the formal language of the tax statute but rather its practical effect, and . . . sustained a tax against Commerce Clause challenge *when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.*”

*Complete Auto Transit, Inc. v. Brady*, 430 U.S. at 279 (citing in a footnote: *General Motors Corp. v. Washington*, supra; *Northwestern Cement Co. v. Minnesota*, 358 U.S. 450, 79 S. Ct. 357, 3 L. Ed. 2d 421 (1959); *Memphis Gas Co. v. Stone*, 335 U.S. 80, 68 S. Ct. 1475, 92 L. Ed. 1832 (1948); and *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 61 S. Ct. 246, 85 L. Ed. 267 (1940)) (emphasis added). The foregoing four factors have become known as “the *Complete Auto* test” and are used to determine the validity of a tax on income derived from activity involving interstate commerce.

Two of VFJ's arguments regarding the constitutionality of Alabama's add-back statute address the elements of the *Complete Auto* test. First, VFJ con-

tends that "the add-back statute is effectively an attempt" to tax the income of Lee and Wrangler and that Alabama lacks a sufficient nexus with those IMCOs to justify the imposition of that tax. See *Complete Auto*, supra; see also *Quill Corp. v. North Dakota*, supra (discussing the requirement that a state have a "sufficient nexus" with a taxpayer in order for the taxpayer to be subject to taxation).

The requirement of a sufficient nexus between the state and the taxpayer has been explained as follows:

"The Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities—even on a proportional basis—unless there is a "minimal connection" or "nexus" between the interstate activities and the taxing State, and "a rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Exxon Corporation v. Wisconsin Dept. of Revenue*, [447 U.S. 207,] 219-220, 100 S. Ct. 2109, 65 L. Ed. 2d 66 [(1980)], quoting *Mobil Oil Corp. v. Commissioner of Taxes*, [445 U.S. 425], 436, 437, 100 S. Ct. 1223, 63 L. Ed. 2d 510 [(1980)]."

*Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. at 165-66.

This court's research has revealed some examples in which a state has attempted to tax income received by an IMCO from a corporation required to pay income tax in that state. In *Comptroller of the Treasury v. SYL, Inc.*, 375 Md. 78, 106, 825 A.2d 399, 415 (2003), the Maryland Court of Appeals addressed two companion cases in which tax audits by Maryland's comptroller of the treasury sought to require a Dela-

were IMCO to pay taxes on franchise fees paid to it by a related-member corporation with activities in Maryland. The tax court had held in each case that there was not a sufficient nexus between the IMCO and the State of Maryland to justify the imposition of the tax on the IMCO. *SYL, Inc. v. Comptroller of the Treasury*, No. C-96-0154-01, 1999 Md. Tax LEXIS 3 (Md. Tax Ct. April 26, 1999) (unpublished opinion); see also *Comptroller of the Treasury v. SYL, Inc.*, supra. In each case, the Circuit Court for Baltimore City affirmed the tax court's reversal of the tax assessment, and the comptroller again appealed. The Maryland Court of Appeals reversed and upheld the tax assessments, concluding that "an appropriate portion" of each IMCO's income was taxable in Maryland. *Comptroller of the Treasury v. SYL, Inc.*, supra. In reaching its holding, however, the Maryland Court of Appeals did not focus on the issue of nexus. Rather, the court based its decision on its determination that neither of the IMCOs at issue had any real economic substance and that the predominant reason for the creation of each IMCO was the avoidance of state taxation. *Comptroller of the Treasury v. SYL, Inc.*, 375 Md. at 106-07, 825 A.2d at 415-16.

In *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13 (1993), the South Carolina Tax Commission took the position that an IMCO was required to pay corporate income tax in that state on income it had received from royalty payments made by a related-member corporation with activities in South Carolina. The South Carolina Supreme Court held that the IMCO had a sufficient nexus with that state to justify the taxation at issue under both the Due Process Clause and the Commerce Clause of the United States Constitution. *Id.*

In the cases discussed above, each state, pursuant to its interpretation of its taxation statutes, specifically sought to impose a tax directly on the out-of-state IMCOs rather than on the corporations that actually conducted activity within the state. Alabama's add-back statute does not expressly impose a tax on Lee and Wrangler, nor has the Department sought to impose a tax directly on those IMCOs. VFJ contends, however, that the add-back statute does effectively impose a tax on the IMCOs. We conclude that the add-back statute does not implicitly (or "effectively") impose a tax on the IMCOs. Rather, the add-back statute disallows a deduction sought by the taxpayer, VFJ, which does have activities in Alabama sufficient to justify its paying corporate income tax in this state. As stated earlier in this opinion, deductions are a matter of legislative grace. *Ex parte State Dep't of Revenue*, 441 So. 2d at 598. We do not agree with VFJ that disallowing a deduction for an expense it pays constitutes a tax on the entities to whom it paid that expense, in this case Lee and Wrangler. Accordingly, we decline to affirm the trial court's judgment on this basis.

We next turn to VFJ's argument that Alabama's add-back statute results in a tax that is not fairly apportioned to Alabama and, therefore, that it fails to meet the third element of the *Complete Auto* test. In discussing this element, the Supreme Court has stated:

"For over a decade now, we have assessed any threat of malapportionment by asking whether the tax is 'internally consistent' and, if so, whether it is 'externally consistent' as well. See *Goldberg [v. Sweet]*, 488 U.S. 252, 261, 109 S. Ct. 582, 102 L. Ed. 2d 607 [(1989)]; *Container Corp.*

[of *America v. Franchise Tax Board*], 463 U.S. [159], at 169, 103 S. Ct. 2933, 77 L. Ed. 2d 545 [(1983)]. Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear. This test asks nothing about the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate. A failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction, since allowing such a tax in one State would place interstate commerce at the mercy of those remaining States that might impose an identical tax. See *Gwin, White & Prince[, Inc. v. Henneford]*, 305 U.S. [434], at 439, 59 S. Ct. 325, 83 L. Ed. 272 [(1939)]. . . .

“External consistency, on the other hand, looks not to the logical consequences of cloning, but to the economic justification for the State’s claim upon the value taxed, *to discover whether a State’s tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State*. See *Goldberg, supra*, at 262; *Container Corp., supra*, at 169-170. Here, the threat of real multiple taxation (though not by literally identical statutes) may indicate a State’s impermissible overreaching.”

*Oklahoma Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. at 185 (emphasis added).

In this case, VFJ has maintained that the add-back statute lacks external consistency, i.e., that it attempts to tax activity beyond that that is fairly attributable to its activity in Alabama. *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, supra. In support of its argument, VFJ cites *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 51 S. Ct. 385, 75 L. Ed. 879 (1931). In that case, the evidence indicated that between 17% and 21% of the taxpayer's income was attributable to its activities in North Carolina. However, the statutory tax provision the taxpayer challenged had allocated approximately 80% of the taxpayer's income to North Carolina for the purpose of imposing a tax on that income. The Supreme Court invalidated the tax, concluding that North Carolina had exceeded its authority in imposing the tax. In so holding, the Supreme Court determined that the evidence demonstrated that the tax "operated unreasonably and arbitrarily" as applied to the taxpayer and that it was "out of all appropriate proportion to the business transacted by the [taxpayer] in [North Carolina]." *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. at 135.

Another case to which VFJ refers this court addresses the issue of fair apportionment. In *Hunt-Wesson, Inc. v. Franchise Tax Board of California*, 528 U.S. 458, 120 S. Ct. 1022, 145 L. Ed. 2d 974 (2000), the taxpayer challenged as unconstitutional the State of California's limitation of a deduction allowed under its tax code. Under the provision at issue in that case, California (a unitary or combined-reporting state) allowed a corporate taxpayer to deduct interest expenses to the extent that the interest expense exceeded other, unrelated income, e.g., income that did not arise out of the taxpayer's activities in California. 528 U.S. at 461-62. The Supreme Court concluded

that, under the facts of that case, the limitation on the deductibility of interest expenses was not a true limit on a deduction but was instead more in the nature of an impermissible tax.

The Supreme Court noted that had California demonstrated that the limitation "reflected the portion of the expense properly related to nonunitary income, the limit would not, in fact, be a tax on nonunitary income" but would instead be a "proper allocation of the deduction." 528 U.S. at 465. The Supreme Court held that the provision at issue was "not a reasonable allocation of expense deductions to the income that the expense generate[d]," and, therefore, it concluded that the provision violated the Due Process Clause and the Commerce Clause. *Hunt-Wesson, Inc. v. Franchise Tax Bd. of California*, 528 U.S. at 468. In reaching its holding, the Supreme Court, quoting *Container Corporation of America v. Franchise Tax Board*, 463 U.S. at 165-66, noted that a state may not impose a tax in the absence of a nexus between the state and the interstate activities or in the absence of a "rational relationship" between the income properly attributable to the state and the "intrastate values of the enterprise." *Hunt-Wesson, Inc. v. Franchise Tax Bd. of California*, 528 U.S. at 464.

We find the facts of this case to be distinguishable from those that would necessitate holdings similar to the holdings of *Hans Rees' Sons, Inc. v. North Carolina*, *supra*, and *Hunt-Wesson, Inc. v. Franchise Tax Board of California*, *supra*. The Department, pursuant to the add-back statute, seeks to disallow the deduction of that part of the royalty payments VFJ made to Lee and Wrangler that is attributable to

Alabama.<sup>9</sup> In other words, the Department seeks to apply VFJ's Alabama apportionment factor to that part of the royalty payments that was not subject to taxation in North Carolina as part of the IMCOs' taxable income in that state. Accordingly, we conclude that the Department's interpretation of the add-back statute is consistent with the requirements of a nexus between Alabama and the interstate activities, i.e., the royalty payments. See *Hunt-Wesson, Inc. v. Franchise Tax Bd. of California*, supra; *Container Corp. of America v. Franchise Tax Bd.*, supra.

Further, the evidence did not demonstrate that the application of the add-back statute has resulted in taxation that is out of proportion to VFJ's activities in this state. The United States Supreme Court has established that it is the burden of VFJ, as the taxpayer, to establish "by 'clear and cogent evidence'" that, as a result of the application of Alabama's add-back statute, "the income attributed to [Alabama] is in fact 'out of all appropriate proportions to the business transacted in [Alabama],' or has 'led to a grossly distorted result.'" *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. at 170 (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 274, 98 S. Ct. 2340, 57 L. Ed. 2d 197 (1978)) (internal citations omitted). In this case, there has been no showing that the tax resulting from the application of Alabama's add-back statute was out of proportion to

---

<sup>9</sup> With regard to the issue of fair apportionment, VFJ has challenged only the Department's interpretation and application of the add-back statute. It has not argued that the add-back statute does not contain a provision requiring fair apportionment. We do not attempt to address that issue on its behalf. See, generally, *Jansen v. State ex rel. Downing*, 273 Ala. 166, 168, 137 So. 2d 47, 48 (1962) (quoted *infra*).

VFJ's activities in Alabama or that the resulting tax reached "beyond that portion of value that is fairly attributable to economic activity within the taxing State [(i.e., Alabama)]." *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. at 185; see also *Container Corp. of America v. Franchise Tax Bd.*, *supra*. Under the facts of this case, we conclude that there exists a rational relationship between the income the Department seeks to add back pursuant to § 40-18-35(b) and the income that is to be included in the determination of VFJ's taxable income. See *Hunt-Wesson, Inc. v. Franchise Tax Bd. of California*, *supra*; *Container Corp. of America v. Franchise Tax Bd.*, *supra*. Accordingly, we hold that VFJ has not demonstrated that the add-back statute results in taxation of income that is not fairly attributable to Alabama.

VFJ also asserts that the add-back statute impermissibly discriminates against interstate commerce. It is well settled that "[a] state may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." *Chemical Waste Mgmt., Inc. v. Hunt*, 504 U.S. 334, 342, 112 S. Ct. 2009, 119 L. Ed. 2d 121 (1992) (quoting *Armco, Inc. v. Hardesty*, 467 U.S. 638, 642, 104 S. Ct. 2620, 81 L. Ed. 2d 540 (1984)). VFJ contends that under the subject-to-tax exception the income-tax burden imposed by the add-back statute "depends upon where the recipient IMCO is located" and, therefore, that it results in differential treatment that rises to the level of unconstitutional discrimination.

In support of its argument, VFJ cites only to authority discussing facially discriminatory statutes. See *South Cent. Tel. Co. v. Alabama*, 526 U.S. 160, 119 S. Ct. 1180, 143 L. Ed. 2d 258 (1999); *Camps*

*Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 117 S. Ct. 1590, 137 L. Ed. 2d 852 (1997); *Fulton Corp. v. Faulkner*, 516 U.S. 325, 116 S. Ct. 848, 133 L. Ed. 2d 796 (1996); and *AT&T Corp. v. Surtees*, 953 So. 2d 1240, 1245 (Ala. Civ. App. 2006). In order to determine whether a statute is facially discriminatory, “the text of the statute must treat in-state economic interests differently from out-of-state economic interests in such a way as to benefit the in-state economic interests and burden the out-of-state economic interests.” *AT&T Corp. v. Surtees*, 953 So. 2d at 1245 (also setting forth examples of cases in which the United States Supreme Court found state statutes to be facially discriminatory).

The subject-to-tax exception of Alabama’s add-back statute specifies that the exception applies when the related member’s income is taxed “in Alabama *or any other state* of the United States.” § 40-18-35(b)(1) (emphasis added). Thus, the subject-to-tax exception challenged by VFJ is implicated regardless of which state imposes a tax on the related member’s income. The language of the subject-to-tax exception clearly indicates that, with regard to that exception, the application of Alabama’s add-back statute does not benefit in-state corporations to the detriment of, or disproportionately to, out-of-state corporations. Accordingly, we must conclude that the add-back statute does not, as VFJ contends, discriminate against interstate commerce on the ground that the subject-to-tax exception results in differential tax treatment between states.

Alternatively, VFJ has asserted in its brief submitted to this court an argument concerning the foreign-jurisdiction portion of the subject-to-tax exception as it relates to the Commerce Clause. See § 40-18-

35(b)(1), Ala. Code 1975. However, VFJ presented no evidence demonstrating that the facts of this case implicate that part of the subsection (b)(1) exception.

“A party establishes standing to bring a challenge under the Commerce Clause when it demonstrates the existence of (1) an actual, concrete and particularized ‘injury in fact’—‘an invasion of a legally protected interest’; (2) a ‘causal connection between the injury and the conduct complained of’; and (3) a likelihood that the injury will be ‘redressed by a favorable decision.’ *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560-61, 112 S. Ct. 2130, 119 L. Ed. 2d 351 (1992). A party must also demonstrate that ‘he is a proper party to invoke judicial resolution of the dispute and the exercise of the court’s remedial powers.’ *Warth [v. Seldin]*, 422 U.S. [490] at 518, 95 S. Ct. 2197, 45 L. Ed. 2d 343 [(1975)].”

*Alabama Alcoholic Beverage Control Bd. v. Henri-Duval Winery, L.L.C.*, 890 So. 2d 70, 74 (Ala. 2003). VFJ, because it has not shown that the foreign-jurisdiction portion of the subsection (b)(1) exception applies in this case, has failed to demonstrate sufficient injury so as to confer standing with regard to this argument. See *Muhammad v. Ford*, 986 So. 2d 1158, 1162, 2007 Ala. LEXIS 266, \*8 (Ala. 2007) (in the absence of a legal injury, “there is no case or controversy for a court to consider”).

In addressing the issue of the constitutionality of Alabama’s add-back statute, this court has addressed only those arguments VFJ has asserted in an effort to support the trial court’s judgment in its favor. We decline to address any other arguments that might have been made regarding the alleged unconstitu-

tionality of Alabama's add-back statute. As the Alabama Supreme Court has explained:

"In passing on the validity of a statute it must be remembered that the legislature, except insofar as specifically limited by the state and federal constitutions, is all-powerful in dealing with matters of legislation; that a legislative act is presumed to be constitutional and valid, and all doubts are to be resolved in favor of its validity; that a statute, if reasonably possible, must be so construed as to sustain its validity and will not be declared invalid unless the court is clearly convinced that it cannot stand; that all questions of propriety, wisdom, necessity, utility and expediency in the enactment of laws are exclusively for the legislature, and are matters with which the courts have no concern."

*Jansen v. State ex rel. Downing*, 273 Ala. 166, 168, 137 So. 2d 47, 48 (1962).

We reverse the trial court's judgment in favor of VFJ, and we remand the case to the trial court for the entry of a judgment consistent with this opinion.

REVERSED AND REMANDED WITH INSTRUCTIONS.

Thomas and Moore, JJ., concur.

Pittman and Bryan, JJ., concur in the result, without writings.

65a

**APPENDIX C**

**IN THE CIRCUIT COURT OF  
MONTGOMERY COUNTY, ALABAMA**

[Filed Jan 24, 2007]

---

CV-03-3172

---

VFJ VENTURES, INC., f/k/a VF JEANSWEAR, INC.,  
*Plaintiff,*

v.

G. THOMAS SURTEES, in his official capacity as  
Commissioner of the Department of Revenue for  
the State of Alabama, and the STATE OF ALABAMA  
DEPARTMENT OF REVENUE,  
*Defendants.*

---

**Order**

This case concerns the application and constitutionality of section 40-18-35(b), Code of Alabama (1975) ("the add-back statute"). The Alabama Department of Revenue (the "Department") issued a Final Assessment to VFJ Ventures, Inc. ("VFJ") for Alabama corporate income tax in the amount of \$1,019,899 on November 6, 2003. VFJ timely appealed the Final Assessment to this Court. A trial was held before this Court from July 26 to July 31, 2006. Although the Final Assessment covers several issues, the sole issue before this Court is the validity under the add-back statute of the Department's requirement that VFJ add the amount of certain royalty payments paid by VFJ to the H.D. Lee Company, Inc. ("Lee") and Wrangler Clothing Corp. ("Wran-

gler”) back to VFJ’s Alabama income for the 2001 tax year. This is a case of first impression in that no other state has issued a ruling concerning the application and constitutionality of add-back statutes. This Court had the benefit of hearing from the premier experts in the fields of taxation and patents and trademarks.

### *Finding of Fact*

VFJ manufactures and markets jeanswear, primarily with the LEE® and WRANGLER® brand names throughout the United States. During 2001, VFJ had two distribution facilities and a cutting facility in Alabama employing approximately 600 employees. Accordingly, VFJ filed an Alabama corporate income tax return and paid income tax to the State of Alabama for that year.

In 2001, VFJ paid \$36,220,000 in royalties to Lee and \$66,420,000 in royalties to Wrangler for the use of dozens of trademarks owned by those corporations in VFJ’s manufacturing and marketing processes. VFJ deducted the royalties as business expenses for federal income tax purposes, and this deduction flowed through to its Alabama income tax return, which uses federal taxable income as the starting point for the calculation of Alabama taxable income.

VFJ, Lee, and Wrangler are among the hundreds of direct or indirect subsidiaries of V.F. Corporation (“VF”), which is headquartered in Greensboro, North Carolina. Lee and Wrangler are Delaware corporations engaged in the business of owning, managing, and licensing extensive trademark portfolios (“intangibles management companies” or “IMCOs”). Their trademark portfolios are quite valuable; one witness

estimated that they were worth approximately \$5 billion.

Lee has been engaged in the business of manufacturing jeanswear since 1889. In 1983, Lee transferred its operating and manufacturing assets to The Lee Apparel Company, Inc., but it retained its trademarks. In 1993, VF created several more companies like Lee that were to hold and manage the many different trademarks it and its subsidiaries used all over the world. These IMCOs, including Wrangler, were located in Delaware. Each IMCO held a different family of trademarks.

The establishment of these IMCOs had beneficial state tax effects for the VF group. If the IMCOs were located in Delaware, their income would not be subject to an income tax, but operating subsidiaries, such as VFJ, could deduct royalties paid to the IMCOs on the state income tax returns in the states in which they were doing business.

At trial, VFJ established several other purposes for segregating the ownership and management of its trademarks into the IMCOs. Centralization of trademarks increased efficiency by concentrating management in one group of employees instead of being spread throughout the various operating subsidiaries around the world. Centralization also allowed the employees to develop the expertise necessary to maintain the necessary registrations and monitor and combat infringement worldwide. The centralization and specialization also reduced duplicative efforts, costs, and reliance on outside counsel, increasing efficiency. VF was able to save at least \$60,000 per month in fees paid to outside counsel when it began its centralized trademark management.

Centralization of trademark management allowed third party licensing efforts to be coordinated and managed. It also allowed easier monitoring of expenses and revenues associated with the intangible assets. Furthermore, centralization of intangible property was also part of a larger effort by VFJ in the 1990s to begin sharing common services (such as data processing, information technology, payroll, treasury, employee benefits and legal services) to capitalize on economies of scale.

The parties vigorously disputed at trial whether segregation of the different families of trademarks into different IMCOs facilitated the ease of sale of VF companies or lines of business. I find that the evidence established that in VF's history of both selling and purchasing several lines of business, such sales were facilitated by having the intangibles owned by an IMCO, thereby avoiding the need to transfer and assign each trademark, which could require thousands of assignments and filings around the world. VF in fact sold two IMCOs, Healthtex Apparel Corp. and Jantzen Apparel Corp., to third party purchasers in recent years and found that the IMCO structure facilitated the transfer of the intangibles.

Segregating the intangible assets into separate management companies provided a more flexible business structure in other ways as well. For example, this structure would give the affiliated group more options in the case of a hostile takeover. It also became easier for the affiliated group to borrow money when it could demonstrate that the IMCOs had valuable assets as potential collateral and steady streams of income, without potential for unforeseen liabilities. The use of several different IMCOs ensured clean title to the different families of trade-

marks, and segregated the liabilities of the operating companies from the very valuable intangible assets. It also made it easier to track the profitability of the different families of trademarks.

There were also several advantages to incorporating the IMCOs in Delaware. Delaware has advanced and favorable corporate law, and the U.S. District Court of Delaware has developed a specialty in intellectual property law. Delaware has an experienced workforce with experienced service providers in the intellectual property area.

VF did an excellent job during the course of this trial convincing the Court that Lee and Wrangler are not merely "shell" corporations, but carry on substantial activities. The Court had the benefit of watching a videotape which set out the entire operation in Delaware. They had 3,200 square feet of office space in Wilmington, Delaware. Lee currently has at least fifteen employees, including two trademark attorneys, six trademark paralegals, one licensing paralegal, three trademark assistants, controller, staff accountant, and receptionist. These employees perform work for Wrangler as well. There was no question that this is a "working office," not just an empty space with a post office box.

The employees monitor and maintain thousands of trademark registrations throughout the world. They license trademarks to VF affiliates like VFJ and also to numerous third parties. In 2001, approximately 22% of Lee's royalty income and 3.2% of Wrangler's royalty income were derived from third parties. Helen Winslow, assistant general counsel of Lee, reviews license applications from third parties and has the authority to turn down a license application from a potential licensee whose products might tarnish a

brand's image or raise liability issues. Ms. Winslow can and often does require a test period for a new licensee or grant a license only in a certain geographic territory. Ms. Winslow engages in negotiations with the licensee, licensee's counsel, and usually a representative from a VF manufacturing company in order to set the terms of the license. Ms. Winslow, a past president of the Delaware State Bar Association, does not merely rubber stamp any paper brought to Lee by a related company.

The IMCOs generally charged the same arm's-length rates for intercompany license agreements as third party license agreements. The general rule was a flat 5% license or royalty fee, as determined by industry standards.

The only criticism of the operation by the Court was the quality control method used. The IMCOs required potential licensees, both related and unrelated, to submit proposed quality standards, however, the Court saw definite room for improvement in this area. The IMCOs then negotiated with potential licensees in order to ensure the quality standards were sufficiently high that the licensees' use of the trademarks would not harm their value. If the standards were acceptable, the IMCO adopted those quality standards for the license; if the potential licensee would not agree to sufficiently high quality standards, no license was granted.

In order to ensure compliance with the standards, the IMCOs entered into "Technical Assistance and Know-How Agreements" with related VF manufacturing companies. In these agreements, the manufacturing entity agreed to provide certain technical assistance to the entities to which the IMCOs licensed particular trademarks. The assistance included pro-

vision of technical know-how and expertise with respect to the design, manufacture, quality control, promotion, marketing and distribution of the branded products. In exchange, the IMCOs reimbursed the manufacturing company for all costs associated with such consulting plus 5%.

The IMCOs monitored all licenses, both VF and third-party, for proper trademark usage. In addition, the IMCOs hired third parties to investigate licensees' factories and ensured that the affiliated group's centralized audit group also investigated factories for quality control. The inspection program also ensured proper quality control over the goods manufactured by licensees.

Lee and Wrangler also engaged in monitoring for potential trademark infringements. The IMCO staff received and reviewed "watch service" reports daily to monitor for trademark applications claiming rights in trademarks that resembled Lee's or Wrangler's trademarks. They also reviewed weekly the *Official Gazette*, a publication of the U.S. Patent and Trademark Office that lists all approved trademark applications. If an IMCO discovered a potential infringement, it took steps to protect its trademarks, including filing court proceedings against the potential infringers if necessary.

VFJ entered into license agreements with Lee and Wrangler that governed the licensing arrangement; these agreements contained terms comparable to those in the IMCOs' agreements with third parties. There is no dispute that the 5% royalty rate was an arm's length rate. Pursuant to these license agreements, VFJ paid royalties in cash to Lee and Wrangler for the use of their trademarks based on the

amount of VFJ's sales. VFJ transferred cash to Lee and Wrangler when making royalty payments.

Lee and Wrangler each file separate corporate income tax returns in North Carolina. Lee apportioned (and paid tax on) 2.8783% of its income to North Carolina for tax year 2001. Wrangler apportioned (and paid tax on) 3.9415% of its income to North Carolina for tax year 2001. In addition, the IMCOs are included in VF group consolidated or combined returns in California, Illinois, Kansas, and Colorado.

VFJ filed Alabama corporate income tax returns in 2000 and 2001. After an audit, the Department issued a Final Assessment to VFJ in the amount of \$1,019,899 on November 6, 2003. VFJ timely appealed the Final Assessment to this Court. The primary adjustment in the audit—and the sole issue in the appeal before this Court—concerns the Department's disallowance of deductions for bona fide royalty payments to Lee and Wrangler under the Department's interpretation of the add-back statute.

### *Opinion*

#### *The Add-back Statute*

In 2001, the Alabama legislature amended section 40-18-35, Code of Alabama (1975), by adding a new subsection (b), commonly referred to as the "add-back statute." This new subsection required corporations, when computing their taxable income, to "add back otherwise deductible ... intangible expenses and costs directly or indirectly paid, accrued, or incurred to . . . one or more related members" unless certain exceptions apply. Ala. Code § 40-18-35(b)(1).

In the instant case, there is no dispute that VFJ and Lee and Wrangler are "related members" or that

the royalties paid by VFJ to Lee or Wrangler constitute "intangible expenses." VFJ deducted these royalty payments as ordinary and necessary business expenses on its federal return, and these deductions flowed through to its Alabama income tax return. Therefore, under the add-back statute the amount of the royalty payments must be added back to VFJ's income, unless, as VFJ claims, an exception applies or the add-back statute is unconstitutional.

### *I. The Unreasonable Exception*

A broad exception to the add-back statute is found in subsection (b)(2). Add-back is not required if "the corporation establishes that the [add-back] adjustments are unreasonable." Ala. Code § 40-18-35(b)(2). The statute has no definition of "unreasonable." Joe Garrett, an attorney with the Alabama Department of Revenue who helped draft the add-back statute, testified that the Department has an interpretation of "unreasonable," but it is not specifically defined in the statute. In 2003, the Department issued a regulation, not applicable during the tax year at issue, that defines the "unreasonable" exception thus: "based on the entirety of the taxpayer's particular facts and circumstances, the adjustments have increased the taxpayer's Alabama income tax liability to an amount that bears no fair relation to the taxpayer's Alabama presence." Ala. Admin. Code r. 810-3-35-.02(3)(h)1.

Because add-back in VFJ's circumstances effectively denies it a deduction for a necessary cost of doing business in Alabama, thereby resulting in a calculation of taxable income that includes income fairly attributable to other states, add-back is unreasonable and thus not required for VFJ.

States have rightfully been concerned about taxpayers taking advantage of IMCO structures by setting up “shell” or “sham” corporations in low-tax jurisdictions such as Delaware or Nevada or several other states and shifting substantial portions of their income to low-tax jurisdictions without any real business activity taking place in those other states. *See, e.g., Syms Corp. v. Comm’r of Revenue*, 765 N.E. 2d 758 (Mass. 2002). In response to taxpayers generating large deductions from these sham or shell corporations, several states passed statutes intended to deny taxpayers tax benefits from these sham corporations. Alabama’s add-back statute is one of these statutes.

Lee and Wrangler, however, are not sham or shell corporations. There were several business purposes for their creation and continued viability. They carry on substantial activities that are vital to the business operations of the VF group. VFJ had a business purpose for making the royalty payments—it needed the use of these valuable trademarks in its operations. The payments also had economic substance—they were made in cash and conferred on VFJ the right to use the trademarks.

Deductions for the cost of doing business are an essential part of any tax on net income. Recognizing this, Alabama has long allowed deductions for “the expenses of carrying on such business.” Subdivision 5, § 454, Code of Alabama (1886). Alabama encourages such deductions for ordinary and necessary business expenses, “[t]he theory being, presumably, that the spending of money to make money should be encouraged to the end that taxes will be paid on the net accomplished.” *Boswell v. Bonham*, 297 So. 2d 379 (Ala. Civ. App. 1974).

An expense is an "ordinary" business expense when it is normal, common, and accepted under the circumstances by the business community. *Welch v. Helvering*, 290 U.S. 111, 113-115 (1933). The testimony revealed that payment of royalties to IMCOs (both related and non-related) is normal, common, and accepted in the business community. An expense is a necessary business expense when it is "appropriate and helpful" in developing the taxpayer's business. *Welch v. Helvering*, 290 U.S. 111, 113 (1933) (also noting that courts "should be slow to override [the taxpayer's] judgment" as to whether an expense is "necessary"). The royalty payments made by VFJ in 2001 were thus ordinary and necessary in its business, giving VFJ the right to manufacture jeanswear with the valuable Lee and Wrangler trademarks.

"Unreasonable" is not defined in the statute; it thus should be interpreted in accordance with the legislature's intent in enacting the statute. *State Dep't of Revenue v. Amerada Hess Corp.*, 788 So. 2d 179 (Ala. Civ. App. 2000). Since the purposes of the add-back statute are to prevent abusive deductions and to ensure that income fairly attributable to Alabama is taxed in Alabama, it is unreasonable to require add-back when these purposes would be frustrated by add-back. Add-back is unreasonable in VFJ's case because VFJ's royalty payments are not abusive—they have economic substance and business purpose—and represent real and necessary costs of doing business in Alabama, and to disallow these deductions would distort the amount of VFJ's income fairly attributable to this state.

Accordingly, considering the language and purpose of the add-back statute, Alabama public policy allowing deductions for business expenses in deter-

mining net income, and the particular facts of this case, I find that it would be "unreasonable" to require add-back to VFJ's royalty payments.

This conclusion is not altered by the fact that the transactions may have been motivated by tax considerations. In the words of Judge Learned Hand:

[A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

*Helvering v. Gregory*, 69 F. 2d 809, 810 (2d Cir. 1934), *aff'd sub nom. Gregory v. Helvering*, 293 U.S. 465 (1935). This principle has long been followed in Alabama law: "A taxpayer may resort to any legal method available to it in an effort to diminish the amount of its tax liability." *West Point Pepperell, Inc. v. State Dep't of Revenue*, 624 So. 2d 579, 582 (Ala. Civ. App. 1992), *writ quashed as improvidently granted*, 624 So. 2d 582 (Ala. 1993) (citing *State v. Pullman-Standard Car Mfg. Co.*, 235 Ala. 493, 179 So. 541 (1938)).

Even though this Court's decision regarding the "unreasonable exception" disposes of this case, the Court must point out that the "add-back statute" also has problems relating to the interpretation of the "subject-to-tax" exception. The statute does not define "income." The Department takes the position that "included in income" means "included in post-apportioned income." VF takes the position that "included in income" means simply "included in (any) income."

The Department's own expert, Peter Enrich, who has never testified as an expert in court, stated the language of the "subject-to-tax" exception "is not the most perspicuous way of stating it." Professor Rick Pomp, VF's expert, testified that the "subject-to-tax" exception did not set out pre or post-apportionment language. It was clear to this Court, that if the legislature had wanted the "subject-to-tax" exception to mean post-apportioned income, then they would have stated it in the statute.

[Because this Court's decision regarding the unreasonable exception disposes of this case, it is not necessary for me to fully discuss the parties' arguments concerning the "subject to tax" exception in subsection (b)(1) or the constitutionality of the add-back statute.]

After listening to days of testimony and reading the parties' briefs, the Court must conclude that the "add-back statute" was a poorly drafted statute. The Court, however, would again state that it does not need to dissect and discuss every provision of the statute as the Court's decision regarding the unreasonable exception disposes of this case.

It is therefore ordered ORDERED, ADJUDGED, and DECREED that the Defendant modify the Final Assessment against the Plaintiff in accordance with the terms of this order.

DONE AND ORDERED this the 24th day of Jan., 2007.

/s/ Tracy S. McCooley  
TRACY S. MCCOOEY  
CIRCUIT JUDGE

**APPENDIX D****STATE STATUTES**

Ala. Code § 40-18-33. Corporate income tax; taxable income.

In the case of a corporation subject to the tax imposed by Section 40-18-31, the term "taxable income" means federal taxable income, without the benefit of federal net operating losses plus the additions prescribed and less the deductions and adjustments allowed by this chapter and as allocated and apportioned to Alabama.

Ala. Code § 40-18-35(b) (2001). Corporate income tax; computation of income.

\* \* \* \*

(b) Restrictions on the deductibility of certain intangible expenses and interest expenses with a related member.

(1) For purposes of computing its taxable income, a corporation shall add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions, with one or more related members, except to the extent the corporation shows, upon request by the commissioner, that the corresponding item of income was in the same taxable year: a. Subject to a tax based on or measured by the related member's net income in Alabama or any other state of the United States, or b. subject to a tax based on or measured by the related member's net income by a foreign nation which has in force an income tax treaty with the United States,

if the recipient was a "resident" (as defined in the income tax treaty) of the foreign nation. For purposes of this section, "subject to a tax based on or measured by the related member's net income" means that the receipt of the payment by the recipient related member is reported and included in income for purposes of a tax on net income, and not offset or eliminated in a combined or consolidated return which includes the payor.

(2) The corporation shall make the adjustments required in subdivision (1) unless the corporation establishes that the adjustments are unreasonable, or the corporation and the Commissioner of Revenue agree in writing to the application or use of alternative adjustments and computations. Nothing in this section shall be construed to limit or negate the commissioner's authority to otherwise enter into agreements and compromises otherwise allowed by law.

(3) The adjustments required in subdivision (1) shall not apply to that portion of interest expenses and costs and intangible expenses and costs if the corporation can establish that the transaction giving rise to the interest expenses and costs or the intangible expenses and costs between the corporation and the related member did not have as a principal purpose the avoidance of any Alabama tax and the related member is not primarily engaged in the acquisition, use, licensing, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property, or in the financing of related entities. If the transaction giving rise to the interest expenses and costs or intangible expenses and costs, as the case may be, has a substantial business purpose and economic substance and contains terms and conditions comparable to a similar

arm's length transaction between unrelated parties, the transaction will be presumed to not have as its principal purpose tax avoidance, subject to rebuttal by the Commissioner of the Department of Revenue.

(4) Nothing in this section shall require a corporation to add to its taxable income more than once any amount of interest expenses and costs or intangible expenses and costs that the corporation pays, accrues or incurs to a related member described in subdivision (1).

(5) Nothing in this section shall be construed to limit or negate the commissioner's authority to make adjustments under this chapter.

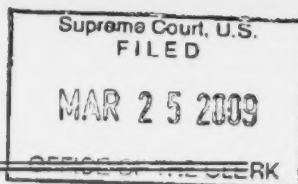
(6) This subsection shall not limit the deduction of the interest portion of rent paid under lease agreements described in subsection (a)(9).

\* \* \* \*

124



No. 08-916



**In The  
Supreme Court of the United States**

VFJ VENTURES, INC., F/K/A VF JEANSWEAR, INC.,

*Petitioner,*

v.

G. THOMAS SURTEES, IN HIS OFFICIAL CAPACITY  
AS COMMISSIONER OF THE DEPARTMENT OF  
REVENUE FOR THE STATE OF ALABAMA, AND  
THE ALABAMA DEPARTMENT OF REVENUE,

*Respondents.*

**On Petition For A Writ Of Certiorari  
To The Supreme Court Of Alabama**

**BRIEF IN OPPOSITION**

HONORABLE TROY KING  
*Attorney General of Alabama*

JEFF PATTERSON\*

*\*Counsel of Record*

JEFF PATTERSON, LLC  
Park Place Center, Suite 204  
8650 Minnie Brown Road  
Montgomery, AL 36117  
(334) 215-4446

*Counsel for Respondents*

## QUESTIONS PRESENTED

Alabama's "add-back" statute requires corporations to "add back" to income any payments made to a related corporate member for intangibles expenses such as royalties or interest, if those payments were deducted from income. The statute provides an exception "to the extent . . . that the corresponding item of income was . . . subject to a tax based on . . . the related member's net income in Alabama or any other state. . . ." The questions presented are:

1. Whether the court below correctly held that there was no Commerce Clause discrimination where the subject-to-tax exception does not favor in-state economic interests.
2. Whether the court below correctly held that the unitary business income of VFJ was fairly apportioned to Alabama using Alabama's standard three-factor apportionment formula.

# TABLE OF CONTENTS

|  | Page |
|--|------|
| QUESTIONS PRESENTED .....  | i    |
| TABLE OF AUTHORITIES .....   | v    |
| STATEMENT OF THE CASE.....   | 1    |
| A. Background of the related intangibles holding company device and the enactment of Alabama's add-back statute .....  | 1    |
| B. VFJ and its related Delaware intangibles holding companies .....  | 4    |
| C. The disallowance of VFJ's deduction for payments to its related intangibles holding companies, and the proceedings below.....   | 7    |
| REASONS FOR DENYING THE PETITION .....   | 11   |
| I. THERE IS NO CONFLICT BETWEEN THE DECISION BELOW AND THIS COURT'S PRECEDENTS.....  | 12   |
| A. The decision below properly applied this Court's Commerce Clause precedents in finding that the facially-neutral subject-to-tax exception does not have the effect of favoring in-state economic activity and therefore does not discriminate against interstate commerce ..... | 12   |

## TABLE OF CONTENTS – Continued

|  | Page |
|--|------|
| B. The decision below properly applied this Court's fair-apportionment precedents in finding that the application of Alabama's standard three-factor apportionment methodology ensures that the add-back statute does not result in an unconstitutional apportionment of income to the state ..... | 19   |
| II. IT WOULD BE WOEFULLY PREMATURE TO REVIEW THE ISSUES RAISED BY VFJ .....  | 27   |
| A. The decision below is the only appellate decision in the nation addressing such statutes .....  | 27   |
| B. The issues now raised by VFJ were severely underdeveloped by VFJ below. Therefore, this case does not constitute a suitable vehicle for discretionary review .....  | 28   |
| III. VFJ'S PETITION DOES NOT PRESENT QUESTIONS OF PUBLIC OR "SURPASSING" IMPORTANCE .....  | 32   |
| A. There is no "cloud of uncertainty" in the states' administration of add-back statutes .....   | 32   |
| B. A reversal in this case would not provide relief to VFJ or to others similarly situated .....   | 32   |

## TABLE OF CONTENTS – Continued

|  | Page |
|--|------|
| C. VFJ's concern for state coffers is un-<br>availing..... | 34   |
| CONCLUSION.....  | 35   |

## TABLE OF AUTHORITIES

## Page

## CASES:

|  |                |
|--|----------------|
| <i>Chemical Waste Mgmt., Inc. v. Hunt</i> , 504 U.S. 334 (1992).....   | 13             |
| <i>Complete Auto Transit, Inc. v. Brady</i> , 430 U.S. 274 (1977).....   | 9, 13, 16, 21  |
| <i>Container Corp. of America v. Franchise Tax Bd.</i> , 463 U.S. 159 (1983) .....   | 20, 22, 24, 29 |
| <i>Ex Parte VFJ Ventures, Inc.</i> , __ So.2d __, 2008 WL 4277998 (Ala. 2008).....   | 11             |
| <i>Fulton Corp. v. Faulkner</i> , 516 U.S. 325 (1996)....  | 17, 18         |
| <i>Geoffrey, Inc. v. South Carolina Dep't of Revenue and Taxation</i> , 437 S.E.2d 13 (S.Car. 1993), cert. denied, 114 S.Ct. 550 (1993)..... | 22             |
| <i>Healy v. Beer Inst., Inc.</i> , 491 U.S. 324 (1989) .....   | 25             |
| <i>Henneford v. Silas Mason Co.</i> , 300 U.S. 577 (1937).....   | 18, 24, 25, 26 |
| <i>Hunt-Wesson, Inc. v. Franchise Tax Bd.</i> , 528 U.S. 458 (2000).....   | 19, 21, 22, 23 |
| <i>King v. Campbell</i> , 988 So.2d 969 (Ala. 2007) .....  | 33             |
| <i>KMart Corp. v. Taxation &amp; Revenue Dep't</i> , 131 P.3d 22 (N.M. 2005).....  | 2              |
| <i>Lanco, Inc. v. Director, Div'n of Tax'n</i> , 908 A.2d 176 (N.J. 2006), cert. denied, 127 S.Ct. 2974 (2007).....                          | 3, 22          |
| <i>Norfolk &amp; W. Ry. Co. v. Missouri State Tax Comm'n</i> , 390 U.S. 317 (1968) .....   | 20, 23         |

## TABLE OF AUTHORITIES – Continued

|  | Page           |
|--|----------------|
| <i>Oklahoma Tax Comm’n v. Jefferson Lines, Inc.</i> ,<br>514 U.S. 175 (1995).....                      | 18, 23, 26, 29 |
| <i>Oregon Waste Systems, Inc. v. Department of<br/>Environmental Quality</i> , 511 U.S. 93 (1994)..... | 13             |
| <i>South Central Bell Telephone Co. v. Alabama</i> ,<br>526 U.S. 160 (1999).....                       | 13             |
| <i>Surtees v. VFJ Ventures, Inc.</i> , __ So.2d __,<br>2008 WL 344118 (Ala. Civ. App. 2008).....       | 9              |
| <i>West Lynn Creamery, Inc. v. Healy</i> , 512 U.S.<br>186 (1994).....                                 | 13             |

## CONSTITUTION, STATUTES, AND RULE:

|  |                    |
|--|--------------------|
| U.S. Const. art. I, § 8, cl. 3 .....       | 10, 11, 12, 13, 17 |
| Acts of Alabama 2001-1088, Section 9 ..... | 33                 |
| Ala. Code § 1-1-16 .....                   | 33                 |
| Ala. Code § 40-2A-7(b)(5)a.....            | 33, 34             |
| Ala. Code § 40-2A-7(b)(5)b.....            | 33, 34             |
| Ala. Code § 40-2A-7(b)(5)b.2.....          | 34                 |
| Ala. Code § 40-2A-9(g).....                | 34                 |
| Ala. Code § 40-18-31(a) .....              | 15                 |
| Ala. Code § 40-18-35(b) .....              | <i>passim</i>      |
| Ala. Code § 40-18-35(b)(1) .....           | 4, 10, 14          |
| Ala. Code § 40-18-35(b)(2) .....           | 9                  |

## TABLE OF AUTHORITIES – Continued

|   | Page |
|---|------|
| Del. Code Ann. Tit. 30, § 6407.....   | 26   |
| Sup. Ct. R. 10.....   | 34   |
| TREATISES:  |      |
| J. Hellerstein & W. Hellerstein, <i>State Taxation</i><br>¶ 9.20[3][j] (2009).....  | 1, 2 |
| MISCELLANEOUS:  |      |
| <i>All States Tax Guide</i> (RIA) ¶ 236-A (2009).....   | 26   |
| <i>All States Tax Guide</i> (RIA) ¶ 5485 (2009) .....   | 25   |
| Donald M. Griswold, <i>Addbacks Add Nothing to<br/>the Debate</i> , 48 State Tax Notes 1073 (June<br>30, 2008) .....  | 31   |
| Glenn R. Simpson, “Diminishing Returns: A<br>Tax Maneuver in Delaware Puts Squeeze on<br>States,” <i>Wall St. J.</i> , Aug. 9, 2002 at A1 .....   | 2    |
| J. Alexander Meleney, <i>Framing the Issues:<br/>Historical Context, Current Debate, and<br/>Relevant Income and Nonincome Tax Consid-<br/>erations</i> , 11 State & Local Tax Lawyer 1<br>(2006), p.7 .....  | 2    |
| Michael Mazerov, <i>Closing Three Common<br/>Corporate Income Tax Loopholes Could Raise<br/>Additional Revenue for Many States</i> 7-8<br>(Center on Budget & Policy Priorities 2002),<br>available at <a href="http://www.cbpp.org/4-9-02sfp.pdf">www.cbpp.org/4-9-02sfp.pdf</a> ..... | 2    |

## TABLE OF AUTHORITIES – Continued

|  | Page |
|--|------|
| Thomas H. Steele & Pilar M. Sansone, <i>Surveying Constitutional Theories for Challenges to the Addback Statutes</i> , 35 State Tax Notes 613 (Feb. 28, 2005)..... | 31   |

## STATEMENT OF THE CASE

### A. BACKGROUND OF THE RELATED INTANGIBLES HOLDING COMPANY DEVICE AND THE ENACTMENT OF ALABAMA'S ADD-BACK STATUTE

Alabama's add-back statute, Ala. Code § 40-18-35(b), was enacted in 2001 as a response to a widely-used state corporate tax avoidance strategy. Starting in the 1980s, and increasingly in the 1990s, many large American businesses established intangibles holding company subsidiaries as a device to minimize their state tax obligations to those states, such as Alabama, that apportion taxpayers' income on a separate-entity basis, as opposed to a combined-reporting basis. As the leading state tax treatise explains, "One of the standard tax-planning devices corporations employ to reduce taxable income in states where they conduct their operations is to transfer their trademarks or trade names to an intangibles holding company (IHC) and license back the trademarks or trade names for a royalty." J. Hellerstein & W. Hellerstein, *State Taxation* ¶ 9.20[3][j] (2009).

By deducting the royalty expenses from the income of the operating company, related corporations can substantially reduce, or even eliminate, the operating company's net income that is subject to apportionment and taxation in the (separate-entity accounting) states where the company operates. Instead, the royalty payments siphon off the income to the intangibles holding company, which is located

in a jurisdiction, like Delaware or Nevada, where such income is not subjected to taxation. The effect is to shelter a very large portion of a business's net income from state taxation, by attributing the income to a state where the business locates only a very small toehold of its actual personnel and physical assets, in what the Hellerstein treatise describes as "transparent efforts to 'game' the system." *Id.*

The intangibles holding company device has been aggressively marketed to businesses by large accounting firms and by Delaware financial and consulting firms, which assist companies in establishing intangibles holding companies and in ensuring that they maintain a sufficient presence in Delaware to rebut allegations of sham transactions. See, e.g., Glenn R. Simpson, "Diminishing Returns: A Tax Maneuver in Delaware Puts Squeeze on States," *Wall St. J.*, Aug. 9, 2002 at A1; *KMart Corp. v. Taxation & Revenue Dep't*, 131 P.3d 22, 23-24 (N.M. 2005). The result has been a rapid spread of the use of this stratagem by large corporations, and, consequently, a significant erosion of state corporate-tax revenues. By the late 1990s, new intangibles holding companies were being formed in Delaware at a rate of 600 to 800 per year. Michael Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States* 7-8 (Center on Budget & Policy Priorities 2002), available at [www.cbpp.org/4-9-02sfp.pdf](http://www.cbpp.org/4-9-02sfp.pdf). See J. Alexander Meleney, *Framing the Issues: Historical Context, Current Debate, and Relevant Income and Nonincome Tax Considerations*, 11

State & Local Tax Lawyer 1, 7 (2006) (describing “the ubiquitous intangible property holding company” as “the most obvious example” of state tax shelters).

The states have adopted a variety of measures in order to stanch the loss of corporate tax revenues from the creation of intangibles holding companies. For example, several states have succeeded in subjecting the holding companies themselves to the state’s corporate income tax, on the grounds that, by licensing their intangibles for use in the state, they were engaging in business activities in the state and, therefore, were subject to the state’s tax. *See, e.g., Lanco, Inc. v. Director, Div’n of Tax’n*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (2007).

However, the most common approach is the path chosen by the Alabama legislature – the enactment of an “add-back” statute, which disallows the deductions that lie at the heart of the intangibles holding company device.<sup>1</sup> The disallowance of royalty-expense deductions paid to a related corporation prevents the siphoning off of the business’s operating income and allows that income to be apportioned and taxed based on where the business actually conducts its income-producing activities.

---

<sup>1</sup> Add-back statutes have been enacted in the vast majority of states that employ separate-entity accounting and that are, therefore, susceptible to the tax-avoidance strategy. Pet. App. 12a n. 3.

The Alabama add-back statute, like those in other states, provides for several exceptions to the disallowance of related-party royalty-expense deductions, and, in the litigation below, the primary issues concerned the statutory interpretation of some of those exceptions. The instant Petition questions the constitutionality of one of those exceptions, which operates to allow the deduction of intangibles expenses paid to a related corporation "to the extent . . . that the corresponding item of income was . . . subject to a tax based on or measured by the related member's net income in Alabama or any other state." Ala. Code § 40-18-35(b)(1). This "subject-to-tax exception" has the effect of eliminating from the apportionable income of a company doing business in Alabama the amounts of any royalty expenses paid by that company to a related company, to the extent that those payments are subjected to state taxation (in Alabama or elsewhere) as part of the related company's income. Thus, the exception protects against any possibility that such income could be subjected to double taxation, once as part of the income of the operating company and again as part of the income of the related intangibles holding company.

## **B. VFJ AND ITS RELATED DELAWARE INTANGIBLES HOLDING COMPANIES**

The top-tier parent of the Vanity Fair corporate family is VF Corporation, which is headquartered in Greensboro, North Carolina. VF Corporation is a parent holding company, and it directly or indirectly

owns the stock of its numerous worldwide subsidiaries, including the Petitioner – VFJ Ventures, Inc. (“VFJ”).

VFJ manufactures, markets, and sells jeanswear – specifically, “Lee” and “Wrangler” jeans. In the State of Alabama during 2001, the year at issue, VFJ had a substantial presence that included two distribution facilities and a cutting facility.

During 2001, VFJ employed approximately 600 people in Alabama, which represented 15.36% of VFJ’s entire payroll. Also in 2001, VFJ had gross sales of approximately \$2.1 billion and federal taxable income of approximately \$93.4 million. VFJ’s Alabama sales during 2001 represented 11.15% of VFJ’s gross sales for that year. Further, the cost of VFJ’s tangible property used to produce business income during 2001 was a little more than one billion dollars, with more than \$163 million worth of that tangible property being located in Alabama.

Starting in the 1980s, VF Corporation segregated the “Lee” and “Wrangler” trademarks into Delaware holding company subsidiaries that now bear those names, and those Delaware holding companies licensed the trademarks back to the VF operating companies for a royalty. In 2001, Lee and Wrangler were among twenty subsidiaries of VF Corporation that shared 3200 square feet of office space in a Delaware office building. Nineteen of those subsidiaries were intangibles holding companies. Of those twenty subsidiaries, only one – Lee – had employees,

and Lee had no more than eleven employees during 2001. The holding companies had no tangible assets or personnel anywhere other than Delaware.

The segregation of the trademarks into Delaware holding companies was coordinated with the licensing of those trademarks back to the operating companies, such as VFJ, which had the operating assets, personnel, and the experience and technical ability to design, manufacture and market the "Lee" and "Wrangler" jeans and other trademarked goods.

Segregating the trademarks into Delaware holding companies created significant state tax benefits for VFJ and for the VF corporate family. During 2001, VFJ paid \$36,220,000 to Lee and \$66,420,000 to Wrangler in royalties, and VFJ deducted the entire \$102,640,000 amount. The effect was to leave VFJ – with its thousands of employees, billion dollars of capital assets, and \$2 billion of sales – with substantially less net income than the combined net income of the two Delaware holding companies – with their one small shared office and handful of shared employees. The deduction for these royalties would have resulted in an Alabama tax savings for VFJ of nearly \$1 million for 2001, but for the enactment of the add-back statute.

Meanwhile, the royalty income of the Delaware holding companies from the licensing of their trademarks was exempt from tax in Delaware. VF Corporation personnel tracked in detail the state tax savings of VFJ that were directly attributable to the

Lee and Wrangler Delaware holding company structure. That structure resulted in a state tax benefit, in the various states where VFJ operated, of \$5,755,678 for the year 2000, and a state tax benefit of \$6,115,488 for 2001.

### **C. THE DISALLOWANCE OF VFJ'S DEDUCTION FOR PAYMENTS TO ITS RELATED INTANGIBLES HOLDING COMPANIES, AND THE PROCEEDINGS BELOW**

Pursuant to the add-back statute, the Alabama Department of Revenue<sup>2</sup> added back to VFJ's apportionable income the majority of VFJ's royalty payments to Lee and Wrangler. Pursuant to the subject-to-tax exception, however, the Department did not add back the amount of the royalty payments that had been subject to tax in North Carolina in the hands of Lee and Wrangler.<sup>3</sup> The Department then applied VFJ's apportionment ratio of 13.9299% to VFJ's apportionable income, including the royalty income that had been added back, using the apportionment ratio that had been provided by VFJ on its 2001 return. VFJ Trial Ex. 2. That ratio had been calculated by VFJ using Alabama's standard three-factor apportionment formula, reflecting the shares of

---

<sup>2</sup> The Department and its Commissioner, as Respondents, are collectively referred to as "the Department."

<sup>3</sup> The exception allowed to VFJ totaled \$3,660,464 (\$1,042,520 relating to Lee and \$2,617,944 relating to Wrangler). Clerk's Record 42.

VFJ's payroll, property, and sales that were located in Alabama.

VFJ misstates the preceding point of fact and law, by stating that "[t]he Department, however, required VFJ to add back the remainder of the royalty payments and assessed tax on that amount of additional income." Pet. 8. This is incorrect. Instead, the amount of royalty payments added back to VFJ's Alabama income was then *apportioned* to Alabama using VFJ's apportionment ratio of 13.9299%. Only that *apportioned* amount of income was taxed by Alabama.

VFJ appealed the tax assessment to circuit court. In Count I of its four-count Complaint, VFJ alleged that it should be entitled to a 100% subject-to-tax exception, solely because Lee and Wrangler reported the royalty income on their North Carolina returns prior to apportionment to that state. In Count II, VFJ alleged that add back would be unreasonable, because VFJ claimed that Lee and Wrangler had "business purpose" and "economic substance," and hence would be eligible for a statutory exception. In Count III, VFJ alleged that the subject-to-tax exception discriminated against interstate commerce. In Count IV, VFJ made non-specific claims as to the Due Process and Equal Protection clauses.

VFJ's primary issue in the litigation was its contention that the purpose of Alabama's add-back statute was to target payments to sham corporations.

Therefore, VFJ's trial evidence focused almost exclusively on VFJ's claim that Lee and Wrangler had business purpose and economic substance, and thus were not shams. Specifically, VFJ proposed that its related holding companies were factually distinct from the typical Delaware intangibles holding company device and, therefore, that VFJ should be granted the "unreasonableness" exception in Ala. Code § 40-18-35(b)(2). Pet. App. 79a. VFJ did not allege, or present any evidence suggesting, that the tax resulting from the application of the add-back statute was out of proportion to the activities of VFJ in Alabama in 2001.

The circuit court ruled in favor of VFJ as to the "unreasonableness" exception, interpreting the add-back statute to be limited to payments to sham corporations. That court did not address VFJ's constitutional claims. Pet. App. 65a-77a.

In a 78-page opinion, the Court of Civil Appeals, sitting en banc, unanimously reversed the circuit court. *Surtees v. VFJ Ventures, Inc.*, \_\_ So.2d \_\_, 2008 WL 344118 (Ala. Civ. App. 2008). In its brief to the Court of Civil Appeals, VFJ's argument concerning constitutionality was limited to four paragraphs, with only one paragraph mentioning fair apportionment and one paragraph mentioning discrimination. As to its discrimination claim, all VFJ argued was the following:

Under *Complete Auto*, *supra*, a state tax may not discriminate against interstate

commerce. Under the "subject-to-tax" exception, the taxpayer's (VFJ, in this case) Alabama corporate income tax burden depends upon where the recipient IMCO is located. The add-back statute thus requires differential tax treatment based merely on where the IMCOs are doing business; this is unconstitutional discrimination.

VFJ Br. 65 (citations omitted).

The appellate court, after reversing the trial court and finding in the Department's favor on the issues of statutory interpretation, analyzed and applied this Court's precedents concerning fair apportionment and Commerce-Clause<sup>4</sup> discrimination. Pet. App. 51a-53a, 56a-62a. The court noted that VFJ did not challenge the Department's add-back calculation, nor did VFJ present any evidence to show that the application of the add-back statute would result in VFJ paying an amount of tax to Alabama that was out of proportion to VFJ's activities in Alabama. Pet. App. 29a-30a, 40a, and 60a-61a.

As to VFJ's discrimination argument, the Court of Civil Appeals held that the subject-to-tax exception, which applies to royalty payments that were subject to tax "in Alabama or any other state of the United States," was facially neutral. Pet. App. 62a (quoting Ala. Code § 40-18-35(b)(1)). The court also stated that "the application of Alabama's add-back

---

<sup>4</sup> U.S. Const. art. I, § 8, cl. 3.

statute does not benefit in-state corporations to the detriment of, or disproportionately to, out-of-state corporations.” Pet. App. 62a. The court concluded by stating that “this court has addressed only those arguments VFJ has asserted in an effort to support the trial court’s judgment in its favor. We decline to address any other arguments that might have been made regarding the alleged unconstitutionality of Alabama’s add back statute.” Pet. App. 63a-64a.

The Alabama Supreme Court, sitting en banc, unanimously affirmed the opinion of the Court of Civil Appeals, and adopted that opinion as its own. *Ex Parte VFJ Ventures, Inc.*, \_\_ So.2d \_\_, 2008 WL 4277998 (Ala. 2008).

---

## REASONS FOR DENYING THE PETITION

A longstanding and well-established state law practice is to adjust a taxpayer’s liability to reflect taxes paid to another state. States routinely provide tax credits in the sales and use tax area, as well as for income taxes paid to another state. Alabama’s subject-to-tax exception to its add-back statute does the same thing and for the same reason, *i.e.* to protect taxpayers from multiple taxation. This Court has never held that such an adjustment violates the Due Process or Commerce Clauses, notwithstanding the fact that the amount of the adjustment depends upon the taxes paid to another state. Not surprisingly, then, the Alabama courts, applying settled doctrine, rejected

VFJ's constitutional arguments. Those decisions do not conflict with any decisions of this Court.

Of course, if state high courts had reached conflicting decisions about the constitutionality of state add-back statutes, this Court's review might be in order. To the contrary, however, even though twenty states have adopted add-back statutes, the decisions of the Alabama Court of Civil Appeals and Alabama Supreme Court are the first and only appellate decisions addressing the issue. Not a single other appellate court in the nation has decided whether a subject-to-tax exception violates the Due Process or Commerce Clauses, let alone reached a contrary conclusion. It is difficult to imagine an issue as to which this Court's intervention would be more premature.

**I. THERE IS NO CONFLICT BETWEEN THE  
DECISION BELOW AND THIS COURT'S  
PRECEDENTS.**

**A. THE DECISION BELOW PROPERLY  
APPLIED THIS COURT'S COMMERCE  
CLAUSE PRECEDENTS IN FINDING  
THAT THE FACIALLY-NEUTRAL SUB-  
JECT-TO-TAX EXCEPTION DOES NOT  
HAVE THE EFFECT OF FAVORING IN-  
STATE ECONOMIC ACTIVITY AND  
THEREFORE DOES NOT DISCRIMI-  
NATE AGAINST INTERSTATE COM-  
MERCE.**

VFJ asserts that the decision below conflicts with the decisions of this Court forbidding state tax provisions

that discriminate against interstate commerce. But, in fact, the Alabama courts correctly stated and applied the applicable constitutional provisions and upheld the subject-to-tax exception because it does not by its terms distinguish between in-state and out-of-state activity and because it does not have the effect of taxing “a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State.” Pet. App. 61a (quoting *Chemical Waste Mgmt., Inc. v. Hunt*, 504 U.S. 334, 342 (1992)).

There is no conflict about the applicable Commerce Clause principles: In order to survive constitutional scrutiny, a state tax measure must “not discriminate against interstate commerce.” *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). “Discrimination,” for these purposes, “simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.” *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 U.S. 93, 99 (1994). This Court has consistently struck down state tax measures that discriminated against interstate commerce either facially, see, e.g., *South Central Bell Telephone Co. v. Alabama*, 526 U.S. 160 (1999), or in their practical effects, see, e.g., *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994).

In the proceedings below, VFJ placed primary emphasis as to its constitutional claims on the claim that the subject-to-tax exception was facially discriminatory. The Alabama courts properly rejected

this argument on the ground that the exception, by its express terms, applies equally whether the “related member’s income is taxed ‘in Alabama or any other state.’” Pet. App. 62a (emphasis in original) (quoting Ala. Code § 40-18-35(b)(1)).

In the instant Petition, VFJ appears to have abandoned the claim of facial discrimination in favor of an argument that the subject-to-tax exception has the impermissibly discriminatory effect of imposing a differential burden that favors transactions that take place entirely within Alabama over those that cross state lines into states (like Delaware) that choose not to tax income from intangibles. Pet. 14-16. As the courts below recognized, *see* Pet. App. 62a, if the subject-to-tax exception actually resulted in such differential treatment benefiting in-state activities or entities, it would indeed violate well-established constitutional norms.

But, in fact, VFJ’s contention that it has such effects is simply mistaken, as VFJ’s own witness at trial acknowledged, and as the courts below found. At trial, VF Corporation’s vice president of tax, who testified that segregating the Wrangler intangibles into a Delaware holding company was his idea, acknowledged on direct examination that moving the Delaware holding companies to Alabama would cause VF to *lose* a tax benefit. Reporter’s Transcript 345-46. Hence, it is not surprising that the Alabama courts found that “the application of Alabama’s add-back statute does not benefit in-state corporations to the

detriment of, or disproportionately to, out-of-state corporations." Pet. App. 62a.

VFJ's claim of a discriminatory practical effect from the subject-to-tax exception hinges on its assertion that locating VFJ's intangibles holding companies in Alabama would result in a tax savings of over \$1 million. Pet. 15. But, in reality, if VF Corporation (the parent) were to relocate the holding companies to Alabama, then those entities would become subject to Alabama tax on their income, which exceeded \$100 million annually from VFJ alone. Thus, while VFJ is correct that such a move would reduce VFJ's Alabama tax liability by slightly over \$1 million, it would do so only at the expense of increasing the holding companies' tax liabilities by approximately \$6.5 million (\$102 million of royalty income, minus deductions for its minimal operating costs, multiplied by Alabama's corporate income tax rate of 6.5%, *see* Ala. Code § 40-18-31(a)). In simple fact, under Alabama's add-back statute, relocating VFJ's related intangibles holding companies into Alabama would sharply increase, not reduce, the state tax liabilities of the business (and with no offsetting reduction in tax liabilities in other states, since the intangibles holding companies were not subject to Delaware tax when located there). The alleged discriminatory effect favoring in-state business activity simply does not exist.

More generally, as a matter of simple arithmetic, the Alabama statute will never provide a tax advantage for relocating a related intangibles holding company into Alabama (or into another state which

subjects income from intangibles to tax). If no exception is applicable, the add-back statute will restore any royalty payments to the operating company's income, but only an apportioned share of that income (reflecting the portion of the operating company's activity that is located in Alabama) will then be taxed by Alabama. By contrast, if the holding company is located in Alabama, then all of its income will be subject to Alabama tax.<sup>5</sup>

In short, the subject-to-tax exception, in its effort to avoid any risk of double taxation of income attributed to the intangibles holding company, has the effect of preserving for a business some of the tax advantage of locating the holding company in a tax-haven state. As a result, the add-back statute disfavors, rather than rewards, businesses that locate a portion of their holding-company activities in Alabama. When evaluated on the basis of its "practical effect," see, e.g., *Complete Auto*, 430 U.S. at 279, 287-89, the subject-to-tax exception offers absolutely none

---

<sup>5</sup> If only a portion of the holding company's activity were relocated to Alabama, then only the applicable portion of its income would be subject to Alabama tax. But, by the same token, only the same portion of that income would be excluded from the apportionable income of the operating company pursuant to the subject-to-tax exception. So, the result would again be an increased tax liability due to the relocation into Alabama.

of the advantages for local economic activity that the Commerce Clause forbids.<sup>6</sup>

Thus, VFJ's claim that the ruling below is in conflict with this Court's decision in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), is entirely unfounded. First, as the Court emphasized, the North Carolina statute in *Fulton Corp.* "facially discriminate[d] against interstate commerce" by expressly "tax[ing] stock only to the degree that its issuing corporation participates in interstate commerce," *id.* at 333, whereas the Alabama subject-to-tax exception is facially neutral. Second, whereas the tax provision in *Fulton Corp.* had the practical effect of "tax[ing] a transaction or incident more heavily when it crosses state lines," Pet. 2 (quoting 516 U.S. at 331), and thus favored in-state economic activity, the Alabama statute challenged here has exactly the opposite

---

<sup>6</sup> In the proceedings below, VFJ similarly argued that the subject-to-tax exception discriminated against the location of intangibles holding companies in states that employ combined unitary accounting or overseas. Before this Court, VFJ has apparently abandoned these arguments. In any case, the arguments fail for precisely the same reason, namely, that relocating a holding company from a combined unitary state, or from a foreign tax haven, to Alabama would actually increase, not decrease, the business's tax liabilities. In addition, as the Department argued below (and as the courts below recognized in the case of foreign locations, see Pet. App. 62a-63a), VFJ lacks standing to assert these arguments, since its holding companies are not located in a combined unitary state or abroad. Further, VFJ waived its combined-reporting argument by not raising it to the appellate court.

effect, imposing a heavier tax burden if the related intangibles holding company were to locate its activities within the state. Alabama's add-back statute, unlike the statute invalidated in *Fulton Corp.* simply does not "place burdens on the flow of commerce across its borders that commerce wholly within those borders would not bear." *Fulton Corp.*, 516 U.S. at 331 (quoting *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 180 (1995)).<sup>7</sup>

---

<sup>7</sup> Moreover, even if a court were to find that Alabama's add-back statute had a discriminatory effect, the question would remain whether the statute served "a legitimate local purpose that cannot be achieved through non-discriminatory means." *Fulton Corp.*, 516 U.S. at 344. Because the constitutional issues were never the primary focus in the litigation below and because there was never a finding of discriminatory effect, the Alabama courts did not have occasion to consider possible justifications for the statute's subject-to-tax exception. Were a court to reach this question, the Department would argue that the exception serves the important interest of avoiding any threat of multiple taxation of the same income; that, as with the use-tax credit for sales taxes already paid, which was approved by this Court in *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937), the Alabama statute serves to ensure that income related to the use of intangibles is taxed once and only once; and, that the subject-to-tax exception therefore serves a legitimate and important state purpose.

**B. THE DECISION BELOW PROPERLY APPLIED THIS COURT'S FAIR-APPORTIONMENT PRECEDENTS IN FINDING THAT THE APPLICATION OF ALABAMA'S STANDARD THREE-FACTOR APPORTIONMENT METHODOLOGY ENSURES THAT THE ADD-BACK STATUTE DOES NOT RESULT IN AN UNCONSTITUTIONAL APPORTIONMENT OF INCOME TO THE STATE.**

VFJ's second asserted ground for review is its claim that the decision below conflicts with this Court's decisions requiring that states must fairly apportion taxes on income from interstate activities. VFJ argues that Alabama's determination of what portion of its income to tax impermissibly looks not to the taxpayer's activities in Alabama but to the tax policies of other states, and that the decision below conflicts with this Court's decision in *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000). In fact, however, the decision below correctly stated and applied this Court's fair-apportionment standard, and properly distinguished *Hunt-Wesson*, a case which did not concern fair apportionment at all.

VFJ's fair-apportionment argument misses the mark so widely that it is hard to know how to respond.<sup>8</sup> The simple fact is that Alabama's add-back

---

<sup>8</sup> The confusion is evidenced by the lack of correspondence between VFJ's second Question Presented, see Pct. at i (making  
(Continued on following page)

statute, and its subject-to-tax exception, are unrelated to Alabama's apportionment methodology. On the contrary, the add-back provisions are applied in calculating a taxpayer's total income that is then subject to apportionment. The income calculated pursuant to the add-back statute is subsequently apportioned to Alabama by use of the standard three-factor formula, which considers the percentages of the taxpayer's payroll, property, and sales that are located in Alabama, a formula which this Court has characterized as "something of a benchmark against which other apportionment formulas are judged." *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 170 (1983).

Thus, VFJ simply is wrong when it asserts that Alabama's statute "attributes income to Alabama based not upon VFJ's conduct in Alabama, but instead upon the tax policy" of other states. Pet. 3. In fact, Alabama attributes income to Alabama based on the percentages of VFJ's payroll, property, and sales that are in Alabama. And, for the same reason, VFJ is equally mistaken when it argues that Alabama's apportionment methodology fails "on its face" to bear a rational relationship to the taxpayer's activity in the state. *Id.* at 23 (quoting *Norfolk & W. Ry. Co. v. Missouri State Tax Comm'n*, 390 U.S. 317, 325 (1968)).

---

no reference to fair apportionment), and its associated argument heading and discussion, see *id.* at 20 (focusing on fair apportionment).

VFJ's claim that the decision below conflicts with this Court's decision in *Hunt-Wesson* fares no better. VFJ's characterization of *Hunt-Wesson* as a case about fair apportionment is thoroughly confused. *Hunt-Wesson* makes no mention whatsoever of apportionment, and is concerned instead with the question of whether the measure challenged there had the effect of taxing income that had no "'rational relationship' or 'nexus'" to the taxing state, *Hunt-Wesson*, 528 U.S. at 464, a question that relates to an entirely different prong of the Court's four-pronged approach to constitutional challenges to state taxes. See *Complete Auto*, 430 U.S. 274, 279 (1977).

In fact, the measure challenged in *Hunt-Wesson*, like Alabama's add-back statute, was concerned with the calculation of *pre*-apportionment, not *post*-apportionment, income, and in particular took the form of a denial of certain deductions that the taxpayer had utilized in calculating its federal taxable income. But the similarity between the cases ends there. The principle involved in *Hunt-Wesson* was that a state cannot tax income that is not connected with the unitary business that the taxpayer conducts in the state. *Hunt-Wesson*, 528 U.S. at 460 (a state "may not tax income received by a corporation from an unrelated business activity which constitutes a discrete business enterprise") (internal quotations omitted). The constitutional flaw in *Hunt-Wesson* was that the denial of the deduction there had the effect of imposing a tax on "nonunitary income" that bore no

“rational relationship or nexus” to the taxpayer’s business in the taxing state. *Id.* at 464-65.

In sharp contrast, there is no suggestion in the present case that Alabama’s add-back statute has the effect of reaching income unrelated to the taxpayer’s activities in Alabama. As the Director of State Taxation for VF Corporation acknowledged at trial, there is no doubt that VFJ and its related intangibles holding companies are engaged in the same unitary business, Reporter’s Transcript 147, as is evidenced by the very substantial “flow of value” between the operating company and the holding companies relating to the use of business trademarks. *See Container Corp.*, 463 U.S. at 178-79. Thus, there is no question that here, unlike in *Hunt-Wesson*, the income that is included in VFJ’s income as a result of the denial of intangibles-expense deductions is income which has a substantial connection with the taxpayer’s income-producing activities in Alabama.<sup>9</sup> Because there is no suggestion or possibility here that Alabama’s add-back statute would have the effect of taxing income that is not part of the unitary business conducted by

---

<sup>9</sup> Indeed, based on this close connection, a number of courts have found that states may impose taxes directly on the income of the intangibles holding companies, even if the only connection of the holding companies to the taxing states is their licensing of their intangibles for use by related companies doing business in the state. *See, e.g., Lanco, Inc. v. Director, Div’n of Tax’n*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (2007); *Geoffrey, Inc. v. South Carolina Dep’t of Revenue and Taxation*, 437 S.E.2d 13 (S.Car. 1993), *cert. denied*, 114 S.Ct. 550 (1993).

the taxpayer in Alabama, *Hunt-Wesson* is entirely inapposite.<sup>10</sup>

Alabama's statute on its face apportions the taxpayer's income to the state by reference to familiar factors that "bear a rational relationship . . . to [the taxpayer's activities] connected with the taxing state," *Norfolk & W. Ry.*, 390 U.S. at 325, and there is no suggestion that the add-back statute results in taxation of any income from a non-unitary business activity unconnected with the state. Thus, the only remaining question concerning fair apportionment is whether Alabama's approach satisfies the requirement of "external consistency," *i.e.* whether it "reaches beyond that portion of value that is fairly attributable to economic activity with the taxing State."<sup>11</sup> *Jefferson Lines*, 514 U.S. at 185.

---

<sup>10</sup> VFJ asserts that the Alabama courts, in characterizing deductions as "a matter of legislative grace," were ignoring the constitutional limitations imposed by *Hunt-Wesson*. See Pet. 24-25. But where such constitutional limitations are inapplicable, as in this case, the Alabama courts' acknowledgement of legislative authority over the granting and denial of deductions is entirely appropriate. Further, the courts' reference to the well-settled rule concerning deductions came, not in response to VFJ's fair-apportionment claim, but rather in response to VFJ's claim below that the add-back statute was a tax on the holding companies, a claim which VFJ has since abandoned. See Pet. App. 56a.

<sup>11</sup> It is undisputed in this case that the Alabama add-back statute satisfies the requirement of "internal consistency." So, that topic requires no discussion.

But, as the courts below correctly recognized, *see* Pet. App. 60a, the taxpayer, in challenging external consistency, bears the heavy burden of establishing “by clear and cogent evidence that the income attributed to the State is in fact out of all appropriate proportions to the business transacted in that State or has led to a grossly distorted result.” *Container Corp.*, 463 U.S. at 170 (internal quotations and citations omitted). In the present case, VFJ made no attempt at trial to present evidence to meet this burden, and the courts below applied the proper standard and correctly concluded that “in this case, there has been no showing that the tax resulting from the application of Alabama’s add-back statute was out of proportion to VFJ’s activities in Alabama.” Pet. App. 60a-61a. Nor could there be such a showing; in fact, Alabama’s tax policy, like that of the twenty other states employing similar add-back statutes in conjunction with standard apportionment rules, provides a reasonable method for apportioning to Alabama a fair share of the income derived from VFJ’s use of the trademarks licensed from its affiliated holding companies.

VFJ seeks to avoid this conclusion by introducing the novel argument that, by taking account of “the tax policy of a sister state” in determining the taxpayer’s Alabama tax, the statute necessarily fails the external consistency standard. Pet. 23-24. Not only is this argument entirely devoid of any support in the decisions of this (or any other) Court, but it in fact directly contradicts the Court’s holding in *Henneford*

*v. Silas Mason Co.*, 300 U.S. 577 (1937), a case which remains a stable fixture in the Court's state-tax jurisprudence. *Silas Mason* upheld the constitutionality of Washington's use tax, and particularly of the provision that rendered the use tax inapplicable to the extent that the goods in question had been subjected to a sales tax either in Washington or some other state. *Id.* at 583-84. As with Alabama's add-back statute, the amount of use tax imposed by Washington depended directly on the tax policies of sister states; if goods were purchased in a state with a sales tax, then Washington did not impose its use tax, whereas if the state of purchase did not tax the sale, then Washington's use tax did apply. Yet, the Court found no constitutional objection to this aspect of Washington's tax scheme.<sup>12</sup> The novel principle that VFJ seeks to invoke would overrule this foundational element of the Court's state-tax case law.

Indeed, state tax systems routinely take account of the tax policies of sister states. Not only does every states' sales and use tax provisions include an exclusion like the one upheld in *Silas Mason*, see *All States Tax Guide* (RIA) ¶ 5485 (2009), but similarly, every states' personal income tax provisions allow resident

---

<sup>12</sup> In upholding Washington's use-tax exclusion, the Court expressly distinguished the case of state price-fixing regulations that involve interstate comparisons and have the effect of projecting a state's regulation across state lines. 300 U.S. at 585-86. For the reasons articulated by Justice Cardozo there, VFJ's appeals to *Healy v. Beer Inst., Inc.*, 491 U.S. 324 (1989), another interstate price-fixing case, are equally inapposite here.

taxpayers a credit for any taxes paid on their income to other states. See *All States Tax Guide* (RIA) ¶ 236-A (2009); see also Del. Code Ann. Tit. 30, § 6407 (granting “headquarters management corporations” a credit against Delaware income tax for income tax paid “to any other state of the United States or the District of Columbia”). Thus, a taxpayer’s income tax in his state of residence will typically vary depending on the tax policies of other states in which he earns income. In each of these cases, as in the case of Alabama’s subject-to-tax exclusion, the effect of the measure is, in fact, to further one of the central purposes of the Court’s fair-apportionment principle, namely, to avoid the threat of multiple taxation, see *Jefferson Lines*, 514 U.S. at 185, by adjusting one state’s tax to take account of tax already paid elsewhere. VFJ’s suggested novel principle would thus have the effect of impeding, not furthering, the purposes of fair apportionment.

A reversal of the decision below would create a direct conflict with *Silas Mason* and would raise serious doubts about the constitutionality of credits for sales or income tax paid to other states. A taxpayer could assert unconstitutionality against such a credit provision, if the taxpayer is not entitled to the credit (or is entitled to less of a credit) because the other state in which the taxpayer has some activity does not impose an income or sales tax (or imposes a tax that is less than some other state’s tax). According to VFJ’s contention, such a credit for tax paid to another state would unconstitutionally discriminate

among states according to whether those states impose an income or sales tax, "*i.e.*, whether they share Alabama's own tax policy." Pet. 18. According to VFJ, such a tax-credit provision would "classically 'Balkaniz[e]' the Nation's economy by setting its tax policy to have different effects on interstate commerce in some States, but not others." Pet. 18. Further, VFJ's contention would support a challenge to such a credit for tax paid to another state as "unconstitutional because it seeks to increase [a taxpayer's] taxable income based not on activity in Alabama, but on the tax policy of a sister State." Pet. 24.

VFJ's contentions as to the add-back statute's subject-to-tax exception are incorrect, as the courts below recognized and held. Moreover, if this Court were to reverse the decision below, well-settled law would be placed in doubt. Therefore, this Court should deny VFJ's petition.

## **II. IT WOULD BE WOEFULLY PREMATURE TO REVIEW THE ISSUES RAISED BY VFJ.**

### **A. THE DECISION BELOW IS THE ONLY APPELLATE DECISION IN THE NATION ADDRESSING SUCH STATUTES.**

Despite the fact that approximately twenty states and the District of Columbia have add-back statutes, the trial-court ruling below was the first court ruling in the nation that addressed the adding back of related-company royalty payments. And, the appellate decisions below still are the only such

appellate decisions in the nation, the obvious consequence of which is that there is no conflict to resolve among the states' highest courts. Therefore, this Court should wait for further analysis and development in the courts below, before involving itself in this subject matter.

**B. THE ISSUES NOW RAISED BY VFJ WERE SEVERELY UNDERDEVELOPED BY VFJ BELOW. THEREFORE, THIS CASE DOES NOT CONSTITUTE A SUITABLE VEHICLE FOR DISCRETIONARY REVIEW.**

Primarily, the case below involved VFJ's attempts to invoke two state-law, statutory exceptions to Alabama's add-back statute, *i.e.*, the subject-to-tax exception and the "unreasonableness" exception. VFJ paid little attention to the constitutional questions it now raises in its Petition. For example, VFJ's second argument to this Court – concerning fair apportionment – is not even identifiable in VFJ's Complaint.

The evidence at trial revolved around VFJ's claim that Lee and Wrangler had business purpose and economic substance, and therefore were not sham corporations. Pursuant to this claim, VFJ sought to invoke the "unreasonableness" exception, and the trial court so ruled without reaching any constitutional issues. The Department appealed.

In VFJ's 68-page brief to the Court of Civil Appeals, VFJ devoted a total of only four paragraphs to

constitutionality. That court reversed the trial court, deciding both of the statutory-exception questions against VFJ. Pet. App. 50a. The court also rejected VFJ's constitutional claims. Throughout its opinion, the Court of Civil Appeals acknowledged that VFJ did not challenge the Department's add-back calculation, and that VFJ did not present any evidence tending to show that the application of the add-back statute would result in VFJ's paying an amount of tax to Alabama that was disproportionate to VFJ's activities in Alabama. Pet. App. 29a-30a, 40a, and 60a-61a (quoting *Container Corp.*, *supra*, and *Jefferson Lines*, *supra*).

As to VFJ's discrimination argument, which consisted of three sentences, the court noted that VFJ cited only to authority discussing facially-discriminatory statutes. Pet. App. 61a-62a. Nevertheless, VFJ now criticizes the court's opinion because, according to VFJ, "it utterly ignores the discriminatory operation of Alabama's add-back regime." Pet. 16. VFJ's criticism is off the mark. The court fully and fairly responded to VFJ's cursory argument by noting that the exception "applies when the related member's income is taxed 'in Alabama or any other state of the United States,'" and by holding that "the application of Alabama's add-back statute does not benefit in-state corporations to the detriment of, or disproportionately to, out-of-state corporations." Pet. App. 62a.

The court cannot be faulted for failing to respond to arguments VFJ did not make, namely, that Alabama was "'project[ing]' its taxing policy 'into other

States,” Pet. 18, or that Alabama was “disallow[ing] the deduction for royalty payments made to States outside Alabama that choose a different tax policy.” Pet. 16. In fact, the court concluded its constitutional analysis by stating that “this court has addressed only those arguments VFJ has asserted in an effort to support the trial court’s judgment in its favor. We decline to address any other arguments that might have been made regarding the alleged unconstitutionality of Alabama’s add back statute.” Pet. App. 63a-64a. The Alabama Supreme Court adopted the opinion of the Court of Civil Appeals as its own. Pet. App. 2a. Thus, the courts below never considered most of the specific constitutional arguments raised by VFJ before this Court.

The record below clearly demonstrates that this case does not present this Court with an “ideal vehicle,” Pet. 30, nor a “comprehensive platform,” Pet. 31, for review, as contended by VFJ. Instead, if this Court were to involve itself in an add-back case, it would be better served to do so where the arguments had been more fully fleshed out below.

VFJ cites to various commentators in its effort to convince this Court that there exists a pressing need for review. Pet. 28, 29. However, VFJ’s commentators primarily are lawyers in private practice who represent taxpayers. In fact, one of the commentators cited by VFJ as “critiquing the decision below and contending that Alabama’s add-back statute is unconstitutional”

actually appears before this Court as a representative of one of VFJ's *amici curiae*.<sup>13</sup> Discretionary review is not appropriate when a petitioner is reduced to essentially citing to itself as a reason for granting its petition.

Even some of VFJ's commentators acknowledge that the issues raised by VFJ are not mature for review. Specifically, VFJ quotes an article entitled *Surveying Constitutional Theories for Challenges to the Addback Statutes*, 35 State Tax Notes 613 (Feb. 28, 2005). Pet. 28 n. 8. The article's next sentence – the one that follows the sentence quoted by VFJ – is insightful: “A taxpayer bringing such a challenge must largely operate in uncharted territory. . . .” 35 State Tax Notes at 620-21. The authors subsequently refer to the type of add-back challenge mounted by VFJ as “blazing new ground.” *Id.* at 622.

Operating in “uncharted territory” to “blaze new ground” is antithetical to the exercise of this Court's discretionary review, especially where the constitutional issues were underdeveloped below. Therefore, VFJ's Petition should be denied.

---

<sup>13</sup> VFJ cites an article entitled *Addbacks Add Nothing to the Debate*, 48 State Tax Notes 1073 (June 30, 2008). Pet. 29 n. 9. The author of that article also appears as one of the counsel for the Institute for Professionals in Taxation, which filed an *amicus curiae* brief in support of VFJ.

### **III. VFJ'S PETITION DOES NOT PRESENT QUESTIONS OF PUBLIC OR "SURPASSING" IMPORTANCE.**

#### **A. THERE IS NO "CLOUD OF UNCERTAINTY" IN THE STATES' ADMINISTRATION OF ADD-BACK STATUTES.**

VFJ contends that the decision below should be reviewed "now," because of what VFJ claims is a "cloud of uncertainty" hovering over the states' administration of add-back statutes. Pet. 29. Simply put, no such cloud exists. The fact that corporations who have employed the intangibles holding company device are displeased with an adverse decision does not mean that the administration of such statutes is uncertain. Instead, what is certain is that the financial stakes are high for those corporations. VFJ's "cloud of uncertainty" claim is an over-dramatization.

#### **B. A REVERSAL IN THIS CASE WOULD NOT PROVIDE RELIEF TO VFJ OR TO OTHERS SIMILARLY SITUATED.**

VFJ challenges only the subject-to-tax exception to Alabama's add-back statute. The court below correctly decided that VFJ failed to show that the exception has any constitutional defect. However, even if this Court were to reverse the decision below, the proper remedy would be to sever the exception, not to invalidate the entire add-back statute.

The legislation enacting the add-back statute specifically provided: "The provisions of this act are

severable. If any part of this act is declared invalid or unconstitutional, that declaration shall not affect the part which remains." Acts of Alabama 2001-1088, Section 9. If the exception were to be severed, the remainder of the add-back statute still would operate in a fair and reasonable manner, subjecting to Alabama tax only a fairly-apportioned share of the income shifted out of Alabama by use of the intangibles holding company device. Hence, the appropriate remedy for a finding of unconstitutionality would be to eliminate the source of the unconstitutionality, while allowing the rest of the legislative enactment to stand. *See King v. Campbell*, 988 So.2d 969, 981 (Ala. 2007) (stating that "[t]his Court is required to sever and save what can be saved in a statute in the event a portion of the statute is determined to be unconstitutional. *See* § 1-1-16, Ala. Code 1975.").

VFJ is incorrect when it states that Alabama requires "taxpayers to pay the tax (or pledge equivalent assets) before obtaining a meaningful opportunity to challenge the tax," citing "Ala. Code § 40-2A-9(g)(b)." Pet. 30. Instead, Alabama law allows a taxpayer the option of appealing an assessment of tax to either the Department's administrative law division ("ALD") or to circuit court. Ala. Code § 40-2A-7(b)(5)a and b. No payment or fee is required for a taxpayer to appeal to the ALD. Ala. Code § 40-2A-7(b)(5)a. Only if the appeal is to circuit court, must a

taxpayer first pay the tax at issue or post a bond or pledge assets. Ala. Code § 40-2A-7(b)(5)b.2.<sup>14</sup>

### C. VFJ'S CONCERN FOR STATE CONFERS IS UNAVAILING.

VFJ presumes to speak on behalf of the states, suggesting, *e.g.*, that this Court save the "administrative costs" of future litigation, and asserting that a "prompt resolution" will benefit even those states that subsequently may consider adopting add-back statutes. Pet. 30. First, the states can fend for themselves in such matters, and Alabama is confident that there is no constitutional defect in its subject-to-tax exception. Second, the possibility of states saving future "administrative costs" falls far short of the standard for discretionary review set forth in Supreme Court Rule 10.

---

<sup>14</sup> The subparagraph "§ 40-2A-9(g)(b)" cited by VFJ, Pet. 30, is non-existent. If VFJ was referring to a subparagraph within Ala. Code § 40-2A-9(g), that subsection addresses appeals to circuit court from a final order of the ALD, and does not address a taxpayer's initial appeal options contained in Ala. Code § 40-2A-7(b)(5)a and b. However, under Ala. Code § 40-2A-9(g), a taxpayer is required to pay the tax only if that taxpayer loses before the ALD.

**CONCLUSION**

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

HONORABLE TROY KING

*Attorney General of Alabama*

JEFF PATTERSON\*

*\*Counsel of Record*

JEFF PATTERSON, LLC

Park Place Center, Suite 204

8650 Minnie Brown Road

Montgomery, AL 36117

(334) 215-4446

*Counsel for Respondents*

March 25, 2009

125

3

No. 08-916

FILED

APR 7 - 2009

OFFICE OF THE CLERK  
SUPREME COURT, U.S.

---

IN THE  
**Supreme Court of the United States**

---

VFJ VENTURES, INC., F/K/A VF JEANSWEAR, INC.,  
*Petitioner,*

v.

G. THOMAS SURTEES, IN HIS OFFICIAL CAPACITY AS  
COMMISSIONER OF THE DEPARTMENT OF REVENUE  
FOR THE STATE OF ALABAMA, AND THE  
ALABAMA DEPARTMENT OF REVENUE,  
*Respondents.*

---

**On Petition for a Writ of Certiorari  
to the Supreme Court of Alabama**

---

**REPLY BRIEF OF PETITIONER**

---

KEVIN C. NEWSOM  
JOHN C. NEIMAN, JR.  
BRADLEY ARANT BOULT  
CUMMINGS LLP  
One Federal Place  
1819 Fifth Avenue North  
Birmingham, AL 35203  
(205) 521-8000

CARTER G. PHILLIPS\*  
PAUL J. ZIDLICKY  
MATTHEW D. KRUEGER  
SIDLEY AUSTIN LLP  
1501 K Street, N.W.  
Washington, D.C. 20005  
(202) 736-8000

*Counsel for Petitioner*

April 7, 2009

\* Counsel of Record

## TABLE OF CONTENTS

|   | Page |
|---|------|
| TABLE OF AUTHORITIES .....  | ii   |
| REPLY BRIEF .....   | 1    |
| I. THE ALABAMA ADD-BACK STATUTE IS<br>CONTRARY TO THIS COURT'S COM-<br>MERCE CLAUSE AND DUE PROCESS<br>CLAUSE PRECEDENTS..... | 4    |
| II. REVIEW IS WARRANTED BECAUSE<br>THE CASE SQUARELY PRESENTS<br>ISSUES OF SURPASSING NATIONAL<br>IMPORTANCE .....            | 9    |
| CONCLUSION .....  | 12   |

# TABLE OF AUTHORITIES

| CASES   | Page    |
|---|---------|
| <i>Associated Indus. of Mo. v. Lohman</i> , 511 U.S. 641 (1994).....                | 6       |
| <i>Camps Newfound/Owatonna, Inc. v. Town of Harrison</i> , 520 U.S. 564 (1997)..... | 9       |
| <i>Complete Auto. Transit, Inc. v. Brady</i> , 430 U.S. 274 (1977).....             | 7       |
| <i>Container Corp. of Am. v. Franchise Tax Bd.</i> , 463 U.S. 159 (1983).....       | 6, 7    |
| <i>Fulton Corp. v. Faulkner</i> , 516 U.S. 325 (1996).....                          | 4       |
| <i>Granholt v. Heald</i> , 544 U.S. 460 (2005).....                                 | 1, 10   |
| <i>Hans Rees' Sons, Inc. v. N.C. ex rel. Maxwell</i> , 283 U.S. 123 (1931).....     | 8       |
| <i>Healy v. Beer Inst., Inc.</i> , 491 U.S. 324 (1989).....                         | 2, 6    |
| <i>Henneford v. Silas Mason Co.</i> , 300 U.S. 577 (1937).....                      | 8       |
| <i>Hughes v. Oklahoma</i> , 441 U.S. 322 (1979)...                                  | 1       |
| <i>Hunt v. Wash. State Apple Adver. Comm'n</i> , 432 U.S. 333 (1977).....           | 2, 5    |
| <i>Hunt-Wesson, Inc. v. Franchise Tax Bd.</i> , 528 U.S. 458 (2000).....            | 3, 7, 9 |
| <i>New Energy Co. of Ind. v. Limbach</i> , 486 U.S. 269 (1988).....                 | 4, 5    |
| <i>Norfolk &amp; W. Ry. v. Mo. State Tax Comm'n</i> , 390 U.S. 317 (1968).....      | 8       |
| <i>Okla. Tax Comm'n v. Jefferson Lines, Inc.</i> , 514 U.S. 175 (1995).....         | 8, 11   |
| <i>Trinova Corp. v. Mich. Dep't of Treasury</i> , 498 U.S. 358 (1991).....          | 7       |

## STATUTES

|                             |   |
|-----------------------------|---|
| 2009 Wisconsin Act 2 .....  | 9 |
| Wis. Stat. § 71.05(6) ..... | 9 |

## TABLE OF AUTHORITIES—continued

|                              | Page |
|------------------------------|------|
| Wis. Stat. § 71.80(23) ..... | 10   |

## SCHOLARLY AUTHORITY

|  |      |
|--|------|
| 1 J. Hellerstein & W. Hellerstein, <i>State Taxation</i> (3d ed. 2008) ..... | 3, 6 |
|--|------|

## REPLY BRIEF

Petitioner VFJ Ventures, Inc. ("VFJ"), and its amici (including the State of Delaware) have shown that certiorari should be granted because the Alabama Supreme Court's decision upholding the Alabama add-back statute conflicts with this Court's decisions on two issues of recurring and nationwide importance. First, the Alabama add-back statute violates the Commerce Clause because it discriminates against interstate transactions by denying a deduction to VFJ because it pays royalties to related Delaware corporations. Pet. 13-19. Second, the add-back statute violates this Court's "fair apportionment" standards because it attributes income to Alabama based not on VFJ's activities in Alabama, but on the tax policies of a sister State. *Id.* at 20-25. Lastly, VFJ and its amici explained the pressing need for this Court to resolve the constitutionality of the Alabama add-back statute. *Id.* at 25-31; Delaware Br. 11-14. Alabama has no answer.

Remarkably, Alabama neither acknowledges nor attempts to respond to the amici brief filed by the State of Delaware, which showed that review should be granted because the add-back statute discriminates against interstate commerce in a manner that undermines Delaware's economic development policies. Delaware Br. 6-7, 11-14. The conflict between the positions of two sovereign States by itself justifies immediate review because the Commerce Clause was designed "ke[ep] to a minimum" "[r]ivalries among the States," *Granholm v. Heald*, 544 U.S. 460, 472 (2005), and thus to avoid "economic Balkanization." *Hughes v. Oklahoma*, 441 U.S. 322, 325-26 (1979).

On the merits, the State admits that if the Alabama add-back statute provides preferential treatment for transactions that occur "entirely within Alabama" over those that take place across state lines, then "it would indeed violate well-established constitutional norms." Opp. 14. That admission is dispositive because, under Alabama's law, VFJ's royalty payments to Lee and Wrangler were not deductible from its Alabama income, but those same payments would have been deductible if Lee and Wrangler were located in Alabama or another State that shares Alabama's tax policies. The effect of that discrimination was to increase VFJ's annual Alabama tax liability "by slightly over \$1 million" simply because Lee and Wrangler are located in Delaware, rather than Alabama. *Id.* at 15.

The State cannot justify this discrimination by arguing that the add-back statute "preserv[es] for a business some of the tax advantage" of locating Lee and Wrangler in Delaware. *Id.* at 16 (emphasis added). To the contrary, the Commerce Clause prohibits Alabama from enacting discriminatory laws that "stri[p] away" any of the "the competitive and economic advantages" that Lee and Wrangler offer VFJ by virtue of their location in a State with a more favorable tax policy. *Hunt v. Wash. State Apple Adver. Comm'n*, 432 U.S. 333, 351 (1977); accord *Healy v. Beer Inst., Inc.*, 491 U.S. 324, 339 (1989). As Delaware explains, the add-back statute violates the Commerce Clause because it "attempt[s] to nullify the benefits that Delaware has chosen to grant as

part of its carefully considered tax policy.” Delaware Br. 7.<sup>1</sup>

As to fair apportionment, the State argues that VFJ’s position “misses the mark so widely” that it does not “know how to respond.” Opp. 19. The tax treatise upon which the State relies, however, clarifies any confusion. It explains, relying on *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000), that where, as here, an add-back statute results in “extraterritorial taxation of income properly attributable to other states,” there is “a substantial argument that the add-back statute, as applied, violates fair-apportionment principles.” 1 J. Hellerstein & W. Hellerstein, *State Taxation* ¶ 7.17[3][d], at S7-17 to -18 (3d ed. 2008).

Finally, the State insists that the Court should “wait” until there are additional decisions addressing the constitutionality of the other add-back statutes from across the country. Opp. 31. That is incorrect. Immediate resolution of the questions presented is important (i) to corporate taxpayers who are being subjected to substantial, unconstitutional tax burdens, (ii) to add-back States, which may eventually have to pay out massive refunds retrospectively, and

---

<sup>1</sup> The State attempts to divert attention from this conclusion by challenging the legitimacy of VFJ’s royalty payments. Opp. 4-11. That discussion is baseless. The trial court found that (i) VFJ’s royalty payments to Lee and Wrangler “have economic substance and business purpose” and (ii) there are multiple business reasons apart from tax planning “for segregating the ownership and management of its trademarks into [Lee and Wrangler].” Pet. App. 67a, 74a-75a. The Alabama appellate courts did not disturb these findings and ruled that the add-back statute was not even intended “to address the issue of sham or fraudulent transactions or deductions.” *Id.* at 36a-37a.

(iii) to States like Delaware, which may “well suffer irreparable harm” if companies decide that “the benefits of [their] tax polic[ies] are too uncertain to justify organizing” there. Delaware Br. 12.

VFJ’s petition should be granted.

**I. THE ALABAMA ADD-BACK STATUTE IS CONTRARY TO THIS COURT’S COMMERCE CLAUSE AND DUE PROCESS CLAUSE PRECEDENTS.**

1. The State of Alabama essentially concedes both the controlling law and the dispositive facts that demonstrate that Alabama’s add-back statute discriminates against interstate commerce in violation of the Commerce Clause.

First, the State admits that this Court has “consistently struck down state tax measures that discriminated against interstate commerce either facially, or in their practical effects.” Opp. 13 (citations omitted). Second, the State agrees that if its add-back statute “resulted in such differential treatment benefiting in-state activities or entities, it would indeed violate well-established constitutional norms.” *Id.* at 14; see, e.g., *Fulton Corp. v. Faulkner*, 516 U.S. 325, 333 (1996). Finally, the State concedes that VFJ’s royalty payments to Lee and Wrangler subjected VFJ to an additional Alabama tax liability of “slightly over \$1 million,” per year (Opp. 15)—a liability that VFJ would have avoided if Lee and Wrangler were located in Alabama or in another State that shares Alabama’s taxing policies. The Alabama add-back statute is a textbook example of legislation that impermissibly discriminates against interstate commerce. See, e.g., *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 274 (1988).

The State's only response is to argue that there is no discrimination because Alabama's "add-back statute disfavors, rather than rewards, businesses that locate a portion of their holding company activities in Alabama." Opp. 16. It does no such thing. As to Petitioner VFJ, the only entity subject to Alabama income tax, the add-back statute imposes more than \$1 million in additional taxes because VFJ pays royalties to related entities in Delaware rather than in Alabama. The add-back statute plainly disfavors interstate commerce.

Further, the State is wrong when it argues that the Alabama add-back statute does not discriminate against interstate commerce because if Lee and Wrangler were relocated to Alabama, then the combined Alabama tax liability of Lee, Wrangler, and VFJ would "sharply increase." *Id.* at 15. Even assuming that the State's calculations were accurate, the reason that relocation of Lee and Wrangler to Alabama would "sharply increase" their Alabama tax liability is not because the Alabama add-back statute "disfavors" Alabama, but because Alabama taxes royalty income and Delaware does not. That difference in tax policy provides Delaware with what it believes is a competitive advantage over other States such as Alabama. Alabama's add-back statute is a discriminatory effort by Alabama to "strip[] away . . . the competitive and economic advantages" that Delaware and other States have made available. *Hunt*, 432 U.S. at 351; accord *New Energy*, 486 U.S. at 275. As the State of Delaware cogently explains, the Alabama add-back statute (and the nearly 20 others like it) violate the Commerce Clause because they seek to "nullify the benefits that Delaware has chosen to grant as part of its carefully considered tax policy." Delaware Br. 7.

Lastly, the discrimination against interstate commerce would not be cured even if, as the State claims, the add-back statute had the effect of "preserving for a business some of the tax advantage of locating the holding company" in a State with favorable tax policies. Opp. 16 (emphasis added). To the contrary, "the magnitude and scope of discrimination have no bearing on the determinative question whether discrimination has occurred." *Associated Indus. of Mo. v. Lohman*, 511 U.S. 641, 650 (1994).

Review should be granted because the Alabama add-back statute violates the Commerce Clause by attempting to "deprive businesses . . . in other States of 'whatever competitive advantages they may possess' based on the conditions of the local market." *Healy*, 491 U.S. at 339.

2. Review also should be granted because the Alabama add-back statute violates this Court's fair-apportionment standards.

The State of Alabama argues that it had trouble responding because VFJ's position is so wide of the mark. Opp. 19. The Hellerstein treatise, which the State cites repeatedly, takes a conflicting view. According to that treatise, where, as here, a taxpayer's royalty payments have "economic substance" and the add-back statute results in "extraterritorial taxation of income properly attributable to other states," application of the add-back statute "might well . . . violate[] fair apportionment principles." 1 Hellerstein, *supra* ¶ 7.17[3][d], at S7-17 to -18. Alabama's add-back statute does indeed violate fair apportionment principles because it results in the taxation of VFJ without regard to any "reasonable sense of how income is generated." *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).

Alabama argues that fair apportionment is not implicated because the add-back statute is “unrelated” to Alabama’s otherwise permissible three-factor apportionment formula. Opp. 19-20. That argument misses the point. The Alabama add-back statute determines whether *any* of the royalty income VFJ paid to Lee and Wrangler should be treated as income of VFJ subject to Alabama’s three-factor apportionment calculation in the first place. See *Container Corp.*, 463 U.S. at 163-65 (discussing the “unitary business/formula apportionment method” as a whole); cf. *Trinova Corp. v. Mich. Dep’t of Treasury*, 498 U.S. 358, 373-79 (1991) (applying fair-apportionment principles to review inclusion of items in tax base subjected to three-factor apportionment formula).

Contrary to Alabama’s claim (Opp. 21-23), VFJ properly relied on *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000), when it showed that the add-back statute violates the fair-apportionment prong of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). VFJ invoked *Hunt-Wesson* because it applied the leading fair-apportionment case—*Container Corp. of America v. Franchise Tax Board*, which held that a State’s apportionment method must “actually reflect a reasonable sense of how income is generated.” 528 U.S. at 466 (quoting *Container Corp.*, 463 U.S. at 169). *Hunt-Wesson* thus stands for the proposition that the Constitution restricts a State’s ability to subject a multistate entity’s income to taxation based on a factor unrelated to how the income is generated. *Id.* That applies four-square to this case because the add-back statute denies VFJ a deduction, and thereby apportions more income to Alabama, based on a factor that does not reflect how VFJ generates

income—i.e., the tax policy of a sister State. Because Delaware's tax policy says nothing about VFJ's activities in Alabama, it should not affect VFJ's tax liability in Alabama.<sup>2</sup>

Nor does VFJ's position remotely "contradict[] the Court's holding in *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937)," Opp. 24-25, or call into question tax credits for taxes paid in another State, *Id.* at 11. In *Henneford*, the Court upheld a tax on the privilege of using tangible personal property within the State. The statute exempted the use of any article that had already been subjected to a sales tax equal to the use tax or greater, so that the use tax effectively applied only to goods purchased out of state. 300 U.S. at 579-81. Although the use tax was facially discriminatory, the combined effect of the sales and use taxes subjected interstate and intrastate commerce to equivalent burdens. *Id.* at 584. Here, the Alabama add-back statute has nothing to do with sales or use taxes, but rather the determination of taxable income, to which this Court has applied an entirely different set of principles. *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 186 (1995).

Alabama's reference to personal income tax credits (Opp. 11, 26-27) fails for a similar reason: Such credits are available to a *taxpayer* that paid income

---

<sup>2</sup> Alabama errs in arguing that this Court's fair-apportionment cases bar only grossly distorted apportionment results. Opp. 23-24. A State's apportionment method must also bear a reasonable relationship to the taxpayer's activity "on its face," *Norfolk & W. Ry. v. Mo. State Tax Comm'n*, 390 U.S. 317, 325 (1968), and cannot be "inherently arbitrary." *Hans Rees' Sons, Inc. v. N.C. ex rel. Maxwell*, 283 U.S. 123, 130 (1931) (quoting *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120-21 (1920)); see also Pet. 23-24 & n.6 (collecting cases).

tax in a sister State, thereby avoiding double taxation and reflecting that the taxpayer had income-earning activities outside the State. In stark contrast, the add-back statute operates with regard to whether *non-taxpayers* (Lee and Wrangler) paid income tax, and thus the add-back statute neither prevents double taxation of VFJ nor reflects anything about how VFJ generated income. As such, the add-back statute is invalid. See *Hunt-Wesson*, 528 U.S. at 466.

## II. REVIEW IS WARRANTED BECAUSE THE CASE SQUARELY PRESENTS ISSUES OF SURPASSING NATIONAL IMPORTANCE.

By asking this Court to “wait” for other state court decisions on add-back statutes (Opp. 28), Alabama seriously downplays the importance of this Court’s nondiscrimination principles, and also the harms that delay would cause to taxpayers and States alike.

Because “even the smallest scale discrimination can interfere with the project of our Federal Union,” this Court has reviewed claims of state discrimination against interstate commerce even when the statute had limited scope or existed in a *single* State. *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 595 (1997). Review is needed here all the more because *many* States have adopted similar add-back statutes with broad effect, extracting millions of dollars in unconstitutional taxes each year. See Pet. 27 n.7. Indeed, since VFJ filed its petition just weeks ago, yet another State has enacted a provision extending add-back requirements to royalty payments.<sup>3</sup> Impermissible discrimination on such

---

<sup>3</sup> 2009 Wisconsin Act 2, § 76 (codified at Wis. Stat. § 71.01(5n), which extends scope of existing add-back provisions at Wis. Stat. § 71.05(6)(a)24, (b)46, to include royalty payments made to a

grand a scale warrants this Court's immediate attention.

Further, the direct conflict between two States addressed in this case is reason enough for this Court's review. Yet, Alabama does not even acknowledge Delaware's participation in this case. Delaware has designed its corporate income tax policies to attract intangibles management companies—and the high-wage, high-skill jobs they offer. Delaware Br. 5. Rather than compete with Delaware on permissible terms, Alabama (and other States) have sought to negate Delaware's policies and discourage taxpayers from outside Delaware from dealing with Delaware companies. As a result, unless this Court intervenes, companies will have constitutionally suspect incentives to reconsider their decisions to locate in Delaware, or to choose not to locate there in the first place. Delaware, in turn, may try to change its tax policies to counter the add-back statutes. See *id.* at 13. The add-back statutes thus foment the very rivalries that the Commerce Clause is intended to prevent. See *Granholm*, 544 U.S. at 472.<sup>4</sup>

---

related member; subject-to-tax exception codified at Wis. Stat. § 71.80(23)(a)2).

<sup>4</sup> Contrary to Alabama's claim (Opp. 28-30), the questions presented here were fully briefed and preserved below. Before the Alabama Supreme Court, VFJ's briefs led off with the federal constitutional challenges and devoted more than 20 pages to them. VFJ Ala. Sup. Ct. Br. 25-34; VFJ Ala. Sup. Ct. Reply Br. 6-18. Alabama responded fully to the constitutional questions presented here. State Ala. Sup. Ct. Br. 17-36. And the opinion adopted by the Alabama Supreme Court adopted a detailed (albeit erroneous) analysis of the court of appeals addressing both of the issues presented here. See Pet. App. 50a-64a. Add to that the trial court's comprehensive factual findings

The uncertainty surrounding add-back statutes poses serious problems, with high stakes, for taxpayers and States alike. Alabama's attempt to discount those concerns falls flat. It comes as no surprise that the lawyers representing clients actually affected by the add-back statute are among those expressing concerns. Opp. 30. Moreover, Alabama's attempt to downplay the importance of this case is belied by the multiple pages it spends describing the prevalence of intangibles holding companies and the substantial tax revenues in play. *Id.* at 1-4.

Finally, not only taxpayers but also States would benefit greatly from this Court's review. If the decision below is left unreviewed, Alabama and nearly 20 other States will continue collecting taxes through the add-back statute that will likely be subject to refund when the statutes are eventually invalidated. Accordingly, this Court should intervene now and provide needed resolution for all parties affected by add-back statutes.<sup>5</sup>

---

(*id.* at 65a-77a), and it is hard to imagine what more could be "developed."

<sup>5</sup> Alabama also claims that review is unwarranted because, in its view, the subject-to-tax exception could be severed from the add-back statute. Opp. 32-33. But the availability of severance is premature because it remains unclear whether any aspect of the add-back statute survives a constitutional challenge. See *Okla. Tax Comm'n*, 514 U.S. at 185. In any event, because severance is an issue addressed only after the constitutional challenge is resolved, it poses no barrier to review.

## CONCLUSION

For these reasons, and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

KEVIN C. NEWSOM  
JOHN C. NEIMAN, JR.  
BRADLEY ARANT BOULT  
CUMMINGS LLP  
One Federal Place  
1819 Fifth Avenue North  
Birmingham, AL 35203  
(205) 521-8000

CARTER G. PHILLIPS\*  
PAUL J. ZIDLICKY  
MATTHEW D. KRUEGER  
SIDLEY AUSTIN LLP  
1501 K Street, N.W.  
Washington, D.C. 20005  
(202) 736-8000

*Counsel for Petitioner*

April 7, 2009

\*Counsel of Record

121

(6)

No. 08-916

Supreme Court, U.S.  
FILED

FEB 23 2009

OFFICE OF THE CLERK

IN THE  
**Supreme Court of the United States**

VFJ VENTURES, INC., f/k/a VF JEANSWEAR, INC.,

*Petitioner,*

*v.*

G. THOMAS SURTEES,  
in his official capacity as Commissioner of the Department  
of Revenue for the State of Alabama, and the  
ALABAMA DEPARTMENT OF REVENUE,

*Respondents.*

ON PETITION FOR A WRIT OF CERTIORARI TO THE  
SUPREME COURT OF ALABAMA

**BRIEF OF THE CHAMBER OF COMMERCE OF THE  
UNITED STATES OF AMERICA AS AMICUS CURIAE  
IN SUPPORT OF PETITIONER**

ROBIN S. CONRAD  
AMAR D. SARWAL  
NATIONAL CHAMBER  
LITIGATION CENTER, INC.  
1615 H Street, N.W.  
Washington, DC 20062  
(202) 463-5337

BERT W. REIN  
*Counsel of Record*  
JOHN E. BARRY  
BRETT A. SHUMATE  
WILEY REIN LLP  
1776 K Street N.W.  
Washington, DC 20006  
(202) 719-7000

*Attorneys for Amicus Curiae*  
*Chamber of Commerce of the United States of America*



## TABLE OF CONTENTS

|   | <i>Page</i> |
|---|-------------|
| TABLE OF CITED AUTHORITIES .....  | ii          |
| INTEREST OF <i>AMICUS CURIAE</i> .....  | 1           |
| SUMMARY OF ARGUMENT .....   | 3           |
| REASONS FOR GRANTING THE PETITION<br>.....  | 6           |
| I. Certiorari Should Be Granted Because<br>The Alabama Tax Statute Impermissibly<br>Seeks To Regulate Commercial Activity<br>That Occurs Entirely Beyond The State's<br>Borders. ....   | 6           |
| II. Certiorari Should Be Granted For The<br>Independent Reason That The Alabama<br>Add-Back Statute Projects Alabama<br>Tax Policy Extraterritorially In Violation Of<br>The Inherent Limitations On State<br>Sovereignty And The Commerce Clause.<br>..... | 15          |
| CONCLUSION .....  | 20          |

## TABLE OF CITED AUTHORITIES

Page

### FEDERAL CASES

|  |           |
|--|-----------|
| <i>BMW of North America, Inc. v. Gore</i> ,<br>517 U.S. 559 (1996) .....   | 5, 16, 17 |
| <i>Baldwin v. G.A.F. Seelig, Inc.</i> ,<br>294 U.S. 511 (1935) .....   | 15        |
| <i>Best &amp; Co. v. Maxwell</i> ,<br>311 U.S. 454 (1940) .....  | 9         |
| <i>Bonaparte v. Tax Court</i> ,<br>104 U.S. 592 (1881) .....   | 16        |
| <i>Brown-Forman Distillers Corp.</i><br><i>v. New York State Liquor Authority</i> ,<br>476 U.S. 573 (1986) ..... | 12, 19    |
| <i>Complete Auto Transit, Inc. v. Brady</i> ,<br>430 U.S. 274 (1977) .....                                       | 7         |
| <i>Container Corp. of America</i><br><i>v. Franchise Tax Board</i> ,<br>463 U.S. 159 (1983) .....                | 5, 7, 9   |
| <i>Department of Revenue v. Davis</i> ,<br>128 S. Ct. 1801 (2008) .....  | 13        |
| <i>Edgar v. MITE Corp.</i> ,<br>457 U.S. 624 (1982) .....  | 7, 11     |

## Cited Authorities

|  | <i>Page</i>   |
|--|---------------|
| <i>Fulton Corp. v. Faulkner</i> ,<br>516 U.S. 325 (1996) .....   | 11, 16        |
| <i>Granholt v. Heald</i> ,<br>544 U.S. 460 (2005) .....  | 19-20         |
| <i>Great Atlantic &amp; Pacific Tea Co. v. Cottrell</i> ,<br>424 U.S. 366 (1976) .....                           | 17            |
| <i>Healy v. Beer Institute, Inc.</i> ,<br>491 U.S. 324 (1989) .....  | <i>passim</i> |
| <i>Huntington v. Attrill</i> ,<br>146 U.S. 657 (1892) .....  | 15            |
| <i>New Energy Co. v. Limbach</i> ,<br>486 U.S. 269 (1988) .....  | 5, 13, 16     |
| <i>New State Ice Co. v. Liebmann</i> ,<br>285 U.S. 262 (1932) .....  | 18            |
| <i>New York Life Insurance Co. v. Head</i> ,<br>234 U.S. 149 (1914) .....  | 16            |
| <i>Oregon v. Ice</i> ,<br>129 S. Ct. 711 (2009) .....  | 18            |
| <i>Oregon Waste Systems, Inc.</i><br><i>v. Department of Environmental Quality</i> ,<br>511 U.S. 93 (1994) ..... | 6             |

*Cited Authorities*

|  | <i>Page</i> |
|--|-------------|
| <i>Quill Corp. v. North Dakota</i> ,<br>504 U.S. 298 (1992) .....                                      | 9           |
| <i>Shaffer v. Heitner</i> ,<br>433 U.S. 186 (1977) .....   | 16          |
| <i>State Farm Mutual Automobile Insurance Co.</i><br><i>v. Campbell</i> ,<br>538 U.S. 408 (2002) ..... | 16          |
| <i>West Lynn Creamery, Inc. v. Healy</i> ,<br>512 U.S. 186 (1994) .....                                | 9           |

**STATE CASES**

|   |    |
|---|----|
| <i>Geoffrey, Inc. v. South Carolina Tax Commission</i> ,<br>437 S.E.2d 13 (S.C. 1993) ..... | 10 |
| <i>Lanco, Inc. v. Director</i> ,<br>908 A.2d 176 (N.J. 2006) .....                          | 10 |

*Cited Authorities**Page***STATE STATUTES**

|  |   |
|--|---|
| Ala. Code § 40-18-1(29) .....            | 8 |
| Ala. Code § 40-18-2(a) .....             | 7 |
| Ala. Code § 40-18-35(b) .....            | 4 |
| Ala. Code § 40-18-35(b)(1) .....         | 8 |
| Ala. Code § 40-27-1, art. IV, 1(a) ..... | 8 |

## INTEREST OF *AMICUS CURIAE*<sup>1</sup>

The Chamber of Commerce of the United States of America ("the Chamber") is the world's largest business federation, representing a membership of more than three million businesses and organizations of every size and in every industry sector and region of the country. A central function of the Chamber is to represent the interests of its members in important matters before the courts, Congress, and the Executive Branch. To that end, the Chamber has filed *amicus* briefs in numerous cases in this Court addressing issues of vital concern to the Nation's business community, and has regularly participated in cases involving the Commerce Clause.

The Chamber has a substantial interest in this case because add-back statutes similar to the Alabama statute at issue in this case have proliferated throughout the Nation, and businesses in all sectors of the economy are disadvantaged by the abuse of state tax laws to regulate out-of-state business activities and to interfere with the tax policies of sister states. Alabama's add-back statute penalizes Alabama corporate taxpayers that are

---

1. No counsel for a party authored this brief in whole or in part, and no such counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than the *amicus curiae*, its counsel or its members, made a monetary contribution to its preparation or submission. The parties have consented to the filing of this brief and such consents are being lodged herewith. Counsel for *amicus* also represent that counsel of record for all parties received notice of *amicus*'s intention to file this brief at least 10 days prior to the due date.

affiliated with corporations in other states that do not share Alabama's tax policy on trademark royalty fees. In practical effect, Alabama discourages multi-state enterprises that have a taxable presence in Alabama from locating trademark properties in sister states that are not marching in lockstep with the Alabama Legislature, and seeks to undermine the tax policies of sister states that, like Delaware, choose to adopt pro-business taxing regimes. The Chamber is filing this *amicus* brief because its members have a strong interest in healthy competition among the states to attract business activities and in the recognition and enforcement of federal constitutional principles that facilitate interstate commerce and prevent one state from imposing its public policy agenda on any other state.

## SUMMARY OF ARGUMENT

This case squarely presents two important questions regarding the limits that the Constitution places on the power of a single state to project its tax policy extraterritorially:

1. Consistent with dormant Commerce Clause principles, does the State of Alabama have a legitimate interest in imposing a tax penalty on an Alabama corporate taxpayer solely because the Alabama taxpayer makes legitimate royalty payments to an affiliated entity that is not taxed on the resulting income under the laws of a sister state?
2. Does the Alabama add-back statute unlawfully burden interstate commerce by projecting Alabama's tax policy nationwide?

The Alabama add-back statute at issue is irreconcilable with the Commerce Clause because the statute is not linked to any legitimate Alabama interest in determining corporate income fairly allocable to commercial activities within Alabama's borders for Alabama tax purposes. In practical effect, the add-back statute: (1) penalizes corporations that are domiciled or do business in Alabama solely on the basis that they are affiliated with out-of-state corporations that have chosen to domicile themselves in states that do not share Alabama's trademark royalty tax policy, and (2) attempts to coerce sister states to fall into lockstep with Alabama's legislative judgments regarding corporate taxation by stripping away the competitive advantages of states that do not share Alabama's tax policies.

Alabama's add-back statute denies corporations an income tax deduction for royalty payments made to affiliated corporations located in states that do not share Alabama's policy of taxing income derived from royalty payments for intangible assets. *See* Ala. Code § 40-18-35(b). Here, the add-back statute operated to deny Petitioner VFJ Ventures, Inc. ("VFJ") a tax deduction solely on the ground that VFJ made royalty payments to affiliated corporations domiciled in Delaware—a state that, unlike Alabama, does not tax income derived from royalty payments. Notwithstanding that the payments were made to affiliated entities, there is no question that VFJ's royalty payments were legitimate business expenses incurred at market rates. Indeed, had VFJ made the same types of payments to unaffiliated entities or to affiliated entities located in Alabama or any other state that shares Alabama's policy of taxing royalty income, VFJ would have been entitled to the deduction. Notwithstanding this manifest intent to regulate business activity and state policies beyond Alabama's borders, the Alabama Supreme Court held that the add-back provision does not violate the Commerce Clause.

The Alabama Supreme Court's holding collides with established Supreme Court precedent that the Commerce Clause and the limit on sovereignty exercised by individual states within the federal union impose fundamental limits on each state's power to regulate extraterritorial commercial activity and to project its laws into other jurisdictions. *See Healy v. Beer Inst., Inc.*, 491 U.S. 324, 336-37 (1989). By directly linking what is, in effect, a surcharge on certain corporate taxpayers in Alabama to the tax policies of other states in which the taxpayer's corporate affiliates are located, the Alabama add-back statute violates both of these

fundamental limits. See *New Energy Co. v. Limbach*, 486 U.S. 269, 274-75 (1988). First, the add-back statute impermissibly regulates interstate commerce by discouraging Alabama corporate taxpayers from licensing trademarks from affiliated corporations located in states that do not share Alabama's tax policy. The statute further penalizes multi-state corporate entities for electing to hold their trademarks in states that do not share Alabama's tax policy. By discriminatorily taxing in-state economic activity on the basis of criteria that relate solely to commercial activity that occurs wholly outside the state's jurisdiction, the Alabama add-back statute violates the Commerce Clause. See, e.g., *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983).

Second, the add-back statute projects Alabama's tax policy beyond Alabama's borders and infringes upon the policy choices of other states by incentivizing those states to adopt the same tax policies as Alabama or suffer the consequences. See, e.g., *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 571-72 (1996). As applied here, the Alabama statute impermissibly undercuts the ability of Delaware and other states to compete for business presence by offering to lower business taxes, and coerces them to fall into lockstep with Alabama's legislative judgments. Consistent with this Court's precedent, Alabama cannot link the application of its add-back statute to the tax policies of other states without violating fundamental limits on its power to tax commercial activity. The Court should grant the petition to reverse the decision below and reject Alabama's attempt to project its tax policies nationwide in excess of its sovereign jurisdiction and in derogation of dormant Commerce Clause principles.

## REASONS FOR GRANTING THE PETITION

### **I. CERTIORARI SHOULD BE GRANTED BECAUSE THE ALABAMA TAX STATUTE IMPERMISSIBLY SEEKS TO REGULATE COMMERCIAL ACTIVITY THAT OCCURS ENTIRELY BEYOND THE STATE'S BORDERS.**

Alabama's add-back statute violates the Commerce Clause by linking the amount of an Alabama corporate taxpayer's liability not to its economic activity in Alabama, but instead to the tax status of affiliated entities located in other states. Whenever an Alabama corporate taxpayer happens to be affiliated with an out-of-state corporate entity to which the Alabama taxpayer has made royalty payments, the Alabama taxpayer's eligibility to deduct those payments turns solely on the tax policies adopted by the sister state in which the out-of-state entity is domiciled. Because Alabama has no legitimate income apportionment interest in tying the Alabama taxpayer's eligibility for a deduction to its affiliation with an out-of-state entity and the taxation of that entity under another state's law, the statute's undeniable purpose and effect is to impermissibly regulate conduct in violation of the Commerce Clause.

The Commerce Clause "has long been understood to have a 'negative' aspect that denies the States the power unjustifiably to discriminate against or burden" interstate commerce. *Or. Waste Sys., Inc. v. Dep't of Env'tl. Quality*, 511 U.S. 93, 98 (1994). It is well-established that the "Commerce Clause . . . precludes the application of a state statute to commerce that takes place wholly outside of the State's borders, whether or

not the commerce has effects within the State." *Healy*, 491 U.S. at 336 (quoting *Edgar v. MITE Corp.*, 457 U.S. 624, 642-43 (1982) (plurality opinion)). "[A] statute that directly controls commerce occurring wholly outside the boundaries of a State exceeds the inherent limits of the enacting State's authority and is invalid regardless of whether the statute's extraterritorial reach was intended by the legislature." *Id.* The "critical inquiry" is "whether the practical effect of the regulation is to control conduct beyond the boundaries of the State." *Id.* Consistent with these fundamental principles, a state only has a legitimate interest in taxing commercial activity that occurs within the state's borders. See *Container Corp.*, 463 U.S. at 164 ("Under both the Due Process and the Commerce Clauses of the Constitution, a state may not, when imposing an income-based tax, tax value earned outside its borders." (internal quotation marks omitted)); see also *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977) (stating that a tax may only be "applied to an activity with a substantial nexus with the taxing State").

Like most states, Alabama imposes an income tax on corporations that are domiciled or do business in Alabama. See Ala. Code § 40-18-2(a). Although Alabama law generally permits an income tax deduction for royalty payments that corporations make for the right to use intangible assets (here, the Lee and Wrangler trademarks), the add-back statute expressly denies the deduction and thus surcharges Alabama taxpayers that make payments to "related members" of an affiliated group unless the income from these payments is "[s]ubject to tax based on or measured by the related member's net income in Alabama or any other state."

*Id.* § 40-18-35(b)(1).<sup>2</sup> Alabama taxes income from royalty payments for intangible assets, *id.* § 40-27-1, art. IV, 1(a), but certain other states, including Delaware, do not.

Based on its operation of manufacturing facilities in Alabama, Petitioner VFJ filed an Alabama income tax return for the 2001 tax year. During that year, VFJ made royalty payments to Lee and Wrangler, Delaware corporations that are “related” to VFJ within the meaning of Alabama’s add-back statute. After VFJ deducted the royalty payments from its Alabama income, Alabama’s Department of Revenue determined that the add-back statute applied because, notwithstanding that the royalty payments were ordinary and necessary expenses made at market rates, the income that Lee and Wrangler earned through the payments was not taxed in Delaware.

Under the Alabama add-back statute, VFJ’s eligibility for a tax deduction for royalty payments is ultimately linked not to VFJ’s commercial activity within Alabama, but to the application of sister state tax policies that have nothing to do with VFJ’s economic activity in Alabama and thus cannot properly be considered in formulating Alabama tax policy. Specifically, the add-back statute places a differential burden on VFJ solely because it made payments to “related members”—here, Lee and Wrangler—located in Delaware as opposed to Alabama or another state

---

2. A “related member” is defined to include entities in any commonly owned corporate group that includes the taxpayer. See *id.* § 40-18-1(29).

that shares Alabama's tax policy. See *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 202 (1994) ("For over 150 years, our cases have rightly concluded that the imposition of a differential burden on any part of the stream of commerce . . . is invalid . . ."). If Lee and Wrangler were located in Alabama or another state that, like Alabama, taxes royalty payments for intangible assets, then the add-back provision would not apply, and the deduction would be available to VFJ. Because Lee and Wrangler are located in Delaware, which does not tax earnings from royalty payments, the add-back provision denies VFJ the income tax deduction.

In operation, the add-back statute is a Trojan Horse that uses a multi-state entity's taxable presence in Alabama to capture additional tax revenues based solely on Alabama's assessment of a separate taxing policy that has nothing to do with commercial activity that takes place inside Alabama's borders. See *Best & Co. v. Maxwell*, 311 U.S. 454, 455 (1940) ("The commerce clause forbids discrimination, whether forthright or ingenious."). As one of 50 states in a federal union, Alabama has no legitimate interest in linking the applicability of the add-back statute to the tax policies adopted by sister states. Consistent with this Court's precedent, see *Container Corp.*, 463 U.S. at 164, Alabama's legitimate interest in taxing commercial activity ends at the Alabama state line, and Alabama is forbidden from taxing in-state economic activity on the basis of criteria (in this case, the tax burden imposed by a sister state on an out-of-state entity) that relates solely to tax policy adopted outside Alabama's borders. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 311 (1992) (holding that "a vendor whose only contacts with the

taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause"). Alabama's add-back statute is not concerned with the tax implications of VFJ's commercial activities *in Alabama*, because VFJ's ability to claim the tax deduction and avoid the add-back statute does not depend on VFJ's activities within the State of Alabama. The economic effect of trademark royalty payments on the income of an Alabama taxpayer like VFJ is the same regardless of whether the entity to which the taxpayer pays the royalties is from Delaware or another state. By making the taxpayer's liability dependent upon (1) whether the taxpayer is part of a multi-state corporate enterprise; and (2) whether the affiliated recipient of the royalty payments is taxed on the income arising from the payments by a sister state, Alabama is not seeking to measure income attributable to Alabama activities, but rather to tax indirectly the income of some out-of-state corporate entities, but not others.<sup>3</sup>

Alabama is, of course, free to satisfy itself that an Alabama corporate taxpayer is not engaged in a "sham" transaction to avoid Alabama taxes by improperly diverting revenues earned from the taxpayer's economic

---

3. The Chamber does not concede that, in the circumstances presented, Alabama has any authority to tax Lee and Wrangler directly on royalties paid by Alabama entities. However, even assuming that Alabama had such authority and had chosen to exercise it, *see, e.g., Lanco, Inc. v. Director*, 908 A.2d 176 (N.J. 2006) (per curiam); *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), the Commerce Clause prohibits Alabama from discriminating against Alabama taxpayers based solely on whether they are affiliated with multi-state entities or domiciled in particular states.

activities within the state. However, consistent with dormant Commerce Clause principles, Alabama does not have a legitimate interest in discriminatorily adjusting the Alabama entity's tax burden based solely on the tax status of an affiliated, out-of-state entity when royalty payments made by an unaffiliated Alabama entity to the same out-of-state payee would be fully deductible. Put another way, Alabama cannot claim to have a *bona fide* interest in discriminatorily taxing an Alabama entity on the ground that an out-of-state affiliate of the Alabama entity has chosen to operate in a state that has adopted a different tax regime than that of Alabama.

"[T]he practical effect" of the Alabama add-back statute "is to control conduct beyond the boundaries of the State." *Healy*, 491 U.S. at 336. By linking to the tax policies of other states and denying a tax deduction to Alabama corporate taxpayers that are affiliated with corporations that have elected to domicile themselves in sister states that impose lower tax burdens, the add-back statute penalizes Alabama corporate taxpayers solely on the basis that they are affiliated with out-of-state corporations that have chosen to hold intellectual property in states that do not share Alabama's tax policy. See *Edgar*, 457 U.S. at 643 (invalidating Illinois law governing tender offers that "purport[ed] to regulate directly and to interdict interstate commerce, including commerce wholly outside the State"). The statute therefore discourages Alabama corporate taxpayers from making royalty payments to or doing business with affiliated entities located in states that do not share Alabama's tax policy. See, e.g., *Fulton Corp. v. Faulkner*, 516 U.S. 325, 343-44 (1996) (holding that North

Carolina's intangibles tax "worked an impermissible result" because a "North Carolina investor will probably favor investment in corporations doing business within the State" (citing cases)). The Alabama statute also deters multi-state corporations from organizing their affairs to minimize the costs associated with interstate commerce (including tax burdens), because the statute makes clear that Alabama intends to capture tax receipts that sister states elect to leave on the table. *See Healy*, 491 U.S. at 341 (noting that Connecticut's price-affirmation statute created disincentives to engage in interstate commerce).

In substance, the extraterritorial consequences of Alabama's add-back statute are no different from the price-affirmation statute struck down by this Court in *Healy*. The Connecticut statute at issue in *Healy* required out-of-state shippers of beer to affirm that their prices in Connecticut were no higher than prices in bordering states. As the Court described it, the price affirmation statute linked "Connecticut beer prices to the prices charged in the border States." *Id.* at 326; *see also Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth.*, 476 U.S. 573 (1986) (invalidating New York price-affirmation statute). According to the *Healy* Court, the Connecticut law had "the undeniable effect of controlling commercial activity occurring wholly outside the boundary of the State" because it locked in beer prices in neighboring states and prevented sellers from reducing their prices outside Connecticut based on local market conditions. 491 U.S. at 337. The Court recognized that the statute "establishes a substantial disincentive for companies doing business in Connecticut to engage in interstate commerce,

essentially penalizing Connecticut brewers if they seek border-state markets and out-of-state shippers if they choose to sell both in Connecticut and in a border State.” *Id.* at 341. The Court had no doubt that this impermissible effect was caused by linking the price-affirmation statute to out-of-state prices. Connecticut’s price-affirmation statute, like others, “short-circuit[ed] normal pricing decisions based on local conditions” because it “linked in-state prices to the lowest price in any [bordering] State.” *Id.* at 340; *see also id.* at 343 (noting that “[b]y tying maximum future prices in one State to the lowest prices in other States,” “affirmation laws control pricing decisions in nonaffirmation States”).

Just as the price affirmation statute in *Healy* penalized local brewers for doing interstate business by making it impossible to lower prices in border states, the Alabama add-back provision creates disincentives to participate in interstate commerce by penalizing Alabama corporate taxpayers for doing business with affiliates located in states that do not share Alabama’s tax policies. That Alabama relies on tax policy, rather than price controls, to pursue its extraterritorial ambitions does not distinguish this case from *Healy*. Indeed, consistent with *Healy*, this Court has invalidated state tax laws that, like Alabama’s add-back statute, link the availability of tax benefits to the tax laws of other states. *See New Energy Co.*, 486 U.S. at 274-75 (holding that an Ohio law that denied a tax credit for ethanol produced in states that did not grant similar tax advantages for ethanol produced in Ohio violated the Commerce Clause); *see also Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1829 (2008) (Kennedy, J., dissenting) (arguing that a state should not be permitted

“to condition tax-free treatment of out-of-state bonds on reciprocal treatment in another State, leading to the discrete market blocs the Constitution was designed to eliminate” (citation omitted)).

The Alabama Supreme Court addressed the wrong issue and ignored the pernicious effects of the add-back statute on interstate commerce when it concluded that the statute “does not benefit in-state corporations to the detriment of, or disproportionately to, out-of-state corporations.” Pet. App. 62a. As *Healy* shows, Alabama simply cannot, consistent with dormant Commerce Clause principles, link the applicability of the add-back provision to other states’ tax policies. Moreover, the Alabama Supreme Court’s defense of the statute based on the concept of *proportionality* is a red herring. *Id.* at 60a-61a. The question presented is not one of degree, but a categorical, threshold question whether, as a matter of constitutional first principles, Alabama has the power to link the applicability of its add-back statute to and collect tax revenue based solely on the tax policies applicable to entities incorporated in sister states. The Court should grant the petition because the Alabama add-back statute seeks to regulate commercial activity and dictate tax policy outside the borders of Alabama and invites other states to manipulate their tax regimes to discriminate against sister states on the basis of their taxing regimes.

**II. CERTIORARI SHOULD BE GRANTED FOR THE INDEPENDENT REASON THAT THE ALABAMA ADD-BACK STATUTE PROJECTS ALABAMA TAX POLICY EXTRATERRITORIALLY IN VIOLATION OF THE INHERENT LIMITATIONS ON STATE SOVEREIGNTY AND THE COMMERCE CLAUSE.**

The Alabama add-back statute is unconstitutional for the independent reason that it violates the well-established principle that no state has the authority to project its legal or policy judgments nationwide. By doing so, Alabama impermissibly attempts to coerce sister states to fall into lockstep with Alabama's legislative judgments regarding corporate taxation and strips sister states of their ability to compete for business activity in interstate commerce.

By virtue of their joinder in a federal union, the states are fundamentally limited in their ability to "project[] one state regulatory regime into the jurisdiction of another State." *Healy*, 491 U.S. at 337; *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 521 (1935) ("New York has no power to project its legislation into Vermont by regulating the price to be paid in that state for milk acquired there."). This Court has long held that state "[l]aws have no force of themselves beyond the jurisdiction of the state which enacts them, and can have extra-territorial effect only by the comity of other states." *Huntington v. Attrill*, 146 U.S. 657, 669 (1892). In particular, it is "impossible to permit the statutes of [a State] to operate beyond the jurisdiction of that State . . . without throwing down the constitutional barriers by which all the States are restricted within the orbits

of their lawful authority and upon the preservation of which the Government under the Constitution depends." *N.Y. Life Ins. Co. v. Head*, 234 U.S. 149, 161 (1914); see also *Gore*, 517 U.S. at 571 ("No State can legislate except with reference to its own jurisdiction . . . . Each State is independent of all the others in this particular." (quoting *Bonaparte v. Tax Court*, 104 U.S. 592, 594 (1881))); *Shaffer v. Heitner*, 433 U.S. 186, 197 (1977) ("[A]ny attempt 'directly' to assert extraterritorial jurisdiction over persons or property would offend sister States and exceed the inherent limits of the State's power.").

This Court's decisions therefore "reflect the Constitution's special concern both with the maintenance of a national economic union unfettered by state-imposed limitations on interstate commerce and with the autonomy of the individual States within their respective spheres." *Healy*, 491 U.S. at 335-36; see also *Fulton*, 516 U.S. at 334 n.3 ("promotion of in-state markets at the expense of out-of-state ones furthers the 'economic Balkanization' that our dormant Commerce Clause jurisprudence has long sought to prevent"). Indeed, "[a] basic principle of federalism is that each State may make its own reasoned judgment about what conduct is permitted or proscribed within its borders, and each State alone can determine what measure of punishment, if any, to impose on a defendant who acts within its jurisdiction." *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 422 (2002). This Court has rejected efforts by one state to encourage the other 49 states to adopt similar policies by discriminating against interstate commerce. See *New Energy Co.*, 486 U.S. at 274 (rejecting argument that "the availability of the tax

credit to some out-of-state manufacturers . . . shows that the Ohio provision, far from discriminating against interstate commerce, is likely to promote it, by encouraging other States to enact similar tax advantages that will spur the interstate sale of ethanol"). Accordingly, regardless of legislative intent, federal courts have a unique obligation to ensure that one state does not impose its law and public policy on any of the other 49 states or on the operation of interstate commerce.

Here, the pernicious effect of Alabama's add-back statute does violence to the fundamental principles of state sovereignty and comity that underpin the Commerce Clause. The add-back statute projects Alabama's policies regarding corporate taxation into sister states by burdening their own tax policy choices and coercing them to adopt Alabama's legislative judgments or suffer the consequences. *See Gore*, 517 U.S. at 572 ("But by attempting to alter BMW's nationwide policy, Alabama would be infringing on the policy choices of other States."); *Great Atl. & Pac. Tea Co. v. Cottrell*, 424 U.S. 366, 379 (1976) (a state "may not use the threat of economic isolation as a weapon to force sister States to" adopt its own legislative judgments). Under the Alabama Supreme Court's view, Alabama is free to manipulate its own scheme of tax deductions to capture additional tax revenue from multi-state corporate entities whenever it concludes that a sister state has unreasonably or unfairly conferred a tax advantage on the out-of-state affiliates of Alabama corporate taxpayers. If sister states do not fall in line and modify their tax regimes to mirror the tax regime adopted by Alabama, any decisions that sister states

make to extend favored tax treatment to multi-state corporate entities doing business in their jurisdictions will be undermined in whole or in part by Alabama's predatory tax stratagem. Alabama's add-back statute effectively uses the concept of corporate affiliation to capture taxes in a discriminatory manner based on whether Alabama believes taxes should be assessed on affiliated corporate taxpayers by other states (here Delaware). While the add-back statute has the appearance of an anti-evasion provision because it is currently limited to payments made to out-of-state related entities, the court below acknowledged that an anti-evasion rationale was both inapplicable to this case and redundant, because Alabama law already permits excessive royalty payments to be disallowed as deductions. Pet. App. 35a-36a. Under the rationale adopted below, Alabama could lawfully choose to apply its add-back statute without regard to affiliation.

To the extent that the Alabama add-back statute acts to coerce sister states to fall in line or suffer the consequences, the statute undermines "the role of the States as laboratories for devising solutions to difficult legal problems." *Oregon v. Ice*, 129 S. Ct. 711, 718-19 (2009); *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("There must be power in the states and the nation to remould, through experimentation, our economic practices and institutions to meet changing social and economic needs."). In particular, the add-back statute strips sister states of their ability to compete in interstate commerce by negating the competitive and economic advantages that states such as Delaware have held out to intellectual property owners in contrast to Alabama's policy of

taxing royalty payments. *See, e.g., Brown-Forman*, 476 U.S. at 580 (noting that a State "may not insist that producers or consumers in other States surrender whatever competitive advantages they may possess"). If Delaware offers tax-favored treatment to the Delaware domiciliary of a multi-state enterprise that also has a taxable presence in Alabama, the Alabama add-back statute blunts the Delaware incentive by taxing the enterprise's related, Alabama domiciliary. The statute concomitantly interferes with the freedom of choice of business enterprises such as *Lee and Wrangler* by undermining or negating the tax advantages that they realized when they elected to locate in states that, like Delaware, do not share Alabama's tax policies. *See Healy*, 491 U.S. at 339 ("States may not deprive businesses and consumers in other States of 'whatever competitive advantages they may possess' based on the conditions of the local market.").

This case is an ideal vehicle for the Court to reinforce the limits on the power of individual states to interfere with interstate commerce through the use of discriminatory state tax policies to regulate out-of-state activities and defeat sister state tax incentive regimes. Because illegitimate and inherently discriminatory statutes similar to the Alabama add-back statute have proliferated nationwide, *see* Pet. 27, this Court's intervention is warranted to reaffirm the constitutional prohibition on "the kind of competing and interlocking local economic regulation that the Commerce Clause was meant to preclude." *Healy*, 491 U.S. at 337. The proliferation of these statutes, in light of state efforts to discriminate against interstate commerce on a whole host of fronts, *see, e.g., Granholm v. Heald*, 544 U.S.

460 (2005), contributes to the “economic Balkanization” that this Court has sought to prevent. Indeed, in a time of economic difficulty when states may seek to foster local business activity by applying favorable tax and regulatory policies within their borders, and sister states may be tempted to offset and deter such initiatives by burdensome impositions on affiliated entities within their borders, review by this Court is imperative.

### CONCLUSION

For the foregoing reasons, the Court should grant the petition and reverse the decision of the Alabama Supreme Court.

Respectfully submitted,

ROBIN S. CONRAD  
AMAR D. SARWAL  
NATIONAL CHAMBER  
LITIGATION CENTER, INC.  
1615 H Street, N.W.  
Washington, DC 20062  
(202) 463-5337

BERT W. REIN  
*Counsel of Record*  
JOHN E. BARRY  
BRETT A. SHUMATE  
WILEY REIN LLP  
1776 K Street N.W.  
Washington, DC 20006  
(202) 719-7000

*Attorneys for Amicus Curiae  
Chamber of Commerce of the United States of America*

FEB 23 2009

OFFICE OF THE CLERK

122 (2)  
No. 08-916

---

In the  
**Supreme Court of the United States**

---

VFJ VENTURES, INC., F/K/A VF JEANSWEAR, INC.,  
*Petitioner,*

v.

G. THOMAS SURTEES, IN HIS OFFICIAL CAPACITY AS  
COMMISSIONER OF THE DEPARTMENT OF REVENUE FOR  
THE STATE OF ALABAMA, AND THE ALABAMA  
DEPARTMENT OF REVENUE,  
*Respondents.*

---

On Petition for a Writ of Certiorari to the  
Supreme Court of Alabama

---

**BRIEF OF THE STATE OF DELAWARE AS AMICUS  
CURIAE IN SUPPORT OF PETITIONER**

---

RICHARD S. GEBELEIN  
*Chief Deputy*

*Attorney General*

LAWRENCE W. LEWIS\*  
*State Solicitor*

JENNIFER D. OLIVA  
*Deputy State Solicitor*

DEPARTMENT OF JUSTICE  
820 NORTH FRENCH ST.  
WILMINGTON, DE 19801  
(302) 577-8400

*\*Counsel of Record*

Counsel for *Amicus Curiae*

---

## TABLE OF CONTENTS

|   |    |
|---|----|
| TABLE OF AUTHORITIES .....  | ii |
| INTEREST OF THE AMICUS .....  | 1  |
| ARGUMENT.....   | 2  |
| I. Alabama's Add-Back Statute Impermissibly<br>Interferes With Delaware's Corporate Tax<br>Policy, Which Is An Integral Component Of The<br>State's Economic Development Program..... | 2  |
| A. Delaware's Tax-Related Economic Develop-<br>ment Efforts .....   | 3  |
| 1. Separate Reporting.....  | 3  |
| 2. Intangible Property Companies.....   | 4  |
| B. The Add-Back Response.....   | 6  |
| II. Delaware Is Constitutionally Entitled To Devise<br>And Implement Its Corporate Tax Policies<br>Without Encroachments From Other States.....                                       | 7  |
| III. This Court Should Resolve The Add-Back Issue<br>Now. ....  | 11 |
| CONCLUSION .....  | 14 |

## TABLE OF AUTHORITIES

## Cases

|  |      |
|--|------|
| <i>Baldwin v. G.A.F. Seelig, Inc.</i><br>294 U.S. 511 (1935) .....                                     | 9    |
| <i>Bigelow v. Virginia</i><br>421 U.S. 809 (1975) .....  | 8    |
| <i>BMW of North America, Inc. v. Gore</i><br>517 U.S. 559 (1996) .....                                 | 8    |
| <i>Bonaparte v. Tax Court</i><br>104 U.S. 592 (1881) .....   | 8    |
| <i>Brown-Forman Distillers Corp. v. New York State<br/>Liquor Auth.</i><br>476 U.S. 573 (1986) .....   | 9    |
| <i>CTS Corp v. Dynamics Corp. of Am.</i><br>481 U.S. 69 (1987) .....                                   | 8    |
| <i>Edgar v. MITE Corp.</i><br>457 U.S. 624 (1982) .....  | 9    |
| <i>Healy v. Beer Institute</i><br>491 U.S. 324 (1989) .....  | 8, 9 |
| <i>McKesson Corp. v. Division of Alcoholic Beverages<br/>&amp; Tobacco</i><br>496 U.S. 18 (1990) ..... | 12   |
| <i>New State Ice Co. v. Liebmann</i><br>285 U.S. 262 (1932) .....                                      | 7    |

|   |   |
|---|---|
| <i>New York Life Ins. Co. v. Head</i>             |   |
| 234 U.S. 149 (1914) .....                         | 8 |
| <i>Phillips Petroleum Co. v. Shutts</i>           |   |
| 472 U.S. 797 (1985) .....                         | 8 |
| <i>Southern Pac. Co. v. Arizona</i>               |   |
| 325 U.S. 761 (1945) .....                         | 9 |
| <i>State Farm Mut. Auto. Ins. Co. v. Campbell</i> |   |
| 538 U.S. 408 (2003) .....                         | 8 |

## Statutes

|  |       |
|--|-------|
| Ala. Code § 40-18-35 .....             | 6, 10 |
| Del. Code Ann. Tit. 10, § 346 .....    | 3     |
| Del. Code Ann. Tit. 30, § 1902 .....   | 3, 4  |
| Del. Code Ann. Tit. 30, § 1903 .....   | 4, 6  |
| Del. Code Ann. Tit. 30, § 2061 .....   | 5     |
| Del. Code Ann. Tit. 30, § 2062 .....   | 5     |
| Del. Code Ann. Tit. 30, § 2301 .....   | 5     |
| Del. Code Ann. Tit. 30, § 6402 .....   | 5     |
| 64 Del. Laws c. 461, § 10 (1984) ..... | 4     |

## Other Authorities

|  |   |
|--|---|
| Delaware Department of Finance, <i>Delaware Fiscal Notebook</i> (2008) ..... | 5 |
|--|---|

|  |   |
|--|---|
| Delaware Department of State: Division of<br>Corporations<br><a href="http://corp.delaware.gov/aboutagency.shtml">http://corp.delaware.gov/aboutagency.shtml</a> .....   | 2 |
| Delaware Economic Development Office:<br>Entrepreneurial and Small Business Development<br><a href="http://dedo.delaware.gov/IPprogram.shtml">http://dedo.delaware.gov/IPprogram.shtml</a> .....                               | 3 |
| William B. Chandler III & Anthony A. Rickey,<br><i>Manufacturing Mystery: A Response To<br/>Professors Carney and Shepherd's "The Mystery<br/>of Delaware Law's Continuing Success"</i><br>2009 U. Ill. L. Rev. 95 (2009)..... | 2 |
| Jerome R. Hellerstein & Walter Hellerstein, <i>State<br/>Taxation</i> ¶ 8.11 (3d ed. 1998 & Supp. 2008).....   | 4 |
| Donald F. Parsons, <i>et al.</i> , <i>Solving the Mystery of<br/>Patentees' "Collective Enthusiasm" for Delaware</i><br>7 Del. L. Rev. 145 (2004).....   | 6 |

## INTEREST OF THE AMICUS

Although not a named party, Delaware's sovereign interests are at the heart of this case.<sup>1</sup> Delaware is a small state, in terms of both geography and population. To compete in the national marketplace, Delaware has made numerous policy judgments aimed at encouraging businesses to locate within its borders. One of those choices has been to adopt a series of laws that give favorable tax treatment to companies that manage intangible property in Delaware.

Alabama's disagreement with Delaware's tax policy is clear. Rather than use constitutionally permissible means to compete with Delaware for business, Alabama has chosen, by enacting the "add-back" statute at issue here, to reach across Delaware's borders and attempt to nullify Delaware law. Alabama's add-back statute requires Alabama companies calculating their Alabama corporate income taxes to "add back" intangibles-related royalty payments that they make to Delaware corporations. By exercising its taxing power extraterritorially, Alabama has eliminated one of the tax advantages that Delaware's General Assembly chose to make available to its corporate citizens. By doing so, Alabama has, in effect, enacted the very sort of interstate tariff that the Constitution and this Court's jurisprudence have sought to prevent.

---

<sup>1</sup> Pursuant to Supreme Court Rule 37.2, Delaware represents that "counsel of record for all parties receive[d] notice of its intention to file an *amicus curiae* brief at least 10 days prior to the due date for the *amicus curiae* brief."

Alabama's add-back statute, unfortunately, is one among many; 18 other jurisdictions have enacted similar measures. Those statutes' practical impact on Delaware's carefully considered policy choices cannot be fully appreciated until this Court definitively determines whether they violate the Constitution. Because Delaware has a keen interest in the prompt vindication of its policy choices—and, frankly, in clarity for its own sake—it urges this Court to grant the petition and decide the questions presented.

## ARGUMENT

### **I. Alabama's Add-Back Statute Impermissibly Interferes With Delaware's Corporate Tax Policy, Which Is An Integral Component Of The State's Economic Development Program.**

Delaware has a long history and a recognized identity as a leader and an innovator in both tax policy and corporation law. Delaware's innovations in those areas have been—and continue to be—essential to Delaware's successful economic development and business recruitment strategies. Despite having a population of fewer than a million people and being the second smallest state in the country geographically, more than 50% of all publicly-traded companies in the United States—including 63% of the Fortune 500—have chosen to incorporate in Delaware. See, e.g., William B. Chandler III & Anthony A. Rickey, *Manufacturing Mystery: A Response To Professors Carney and Shepherd's "The Mystery of Delaware Law's Continuing Success,"* 2009 U. Ill. L. Rev. 95, 99 (2009); Delaware Dep't of State: Division of Corporations, <http://corp.delaware.gov/aboutagency.shtml> (visited Feb. 13, 2009).

Delaware has long appreciated the evolving nature of the American economy and, in particular, the need to develop the emerging technology and intellectual property industries. Accordingly, it has launched initiatives designed to make the state attractive to high-tech and knowledge-based businesses. Delaware's more notable efforts include the innovative Intellectual Property Business Creation Program, *see* Delaware Economic Development Office: Entrepreneurial and Small Business Development, <http://dedo.delaware.gov/IPprogram.shtml> (visited Feb. 13, 2009), and recent legislation enabling the state's Court of Chancery to mediate "technology disputes," *see* Del. Code Ann. Tit. 10, § 346.

A key component of Delaware's economic development strategy is its corporate tax policy, several features of which are designed specifically to attract business to the state and, as particularly relevant here, to benefit companies engaged in the management of intangible assets and investments. "Add-back" statutes like Alabama's constitute an unconstitutional assault on Delaware's tax-related policy judgments and business development initiatives.

#### **A. Delaware's Tax-Related Economic Development Efforts**

##### **1. Separate Reporting**

Delaware, like Alabama, is a "separate return" state. *See* Del. Code Ann. Tit. 30, § 1902(a). This means that Delaware does not tax business entities without nexus to the state, even if those entities engage in a unitary business with companies that do operate in Delaware. Separate reporting gives corporate groups the flexibility to order their affairs so that income earned by affiliates in

other states is not taxed in Delaware. *See, e.g.,* Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 8.11 (3d ed. 1998 & Supp. 2008). In addition, business entities in Delaware receive state tax deductions for amounts paid to related out-of-state companies. *See* Del. Code Ann. Tit. 30, §§ 1902(a), 1903(a). Delaware has consistently applied separate reporting principles and has not attempted, by way of an add-back statute or otherwise, to reach across state lines and effectively undermine or disregard the legal separateness of corporate entities.

## 2. Intangible Property Companies

In 1984, Delaware clarified the scope of a corporate income tax exemption for companies that specialize in managing intangible property. *See* 64 Del. Laws c. 461, § 10 (1984). These corporations—often called intangibles holding companies, or “IHCs”—are exempt from Delaware corporate income tax so long as they limit their Delaware activities as provided by statute. *See* Del. Code Ann. Tit. 30, § 1902(b)(8).<sup>2</sup>

The H.D. Lee Company, Inc. and Wrangler Apparel Corp. (hereinafter, “Lee” and “Wrangler,” respectively) are Delaware corporations that manage intangible property for the Petitioner (Pet. 2) and, accordingly, pay no

---

<sup>2</sup> To earn tax-exempt status, IHCs must limit their activities to the following: “the maintenance and management of their intangible investments or of the intangible investments of corporations or statutory trusts or business trusts registered as investment companies under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 *et seq.*) and the collection and distribution of the income from such investments or from tangible property physically located outside this State.” Del. Code Ann. Tit. 30, § 1902(b)(8).

Delaware corporate income tax. Lee and Wrangler are also exempt from the state annual license fee and gross receipts tax. *See* Del. Code Ann. Tit. 30, § 2301(o).

These exemptions advance Delaware's considered policy decision to encourage IHCs to locate in-state. That policy is eminently sensible. IHCs like Lee and Wrangler (1) provide jobs with competitive compensation for Delaware citizens; (2) create business for Delaware service-providers, including accountants, lawyers, and specialized administrative support personnel; and (3) do so with only minimal impact on Delaware's environment and infrastructure. Moreover, although the IHCs themselves do not pay corporate income taxes, they generate additional revenue for the state through the income and other taxes paid by their employees and service providers. This tradeoff between corporate and individual income taxes is one that Delaware has made purposefully, and this reasoned policy choice has benefited Delaware accordingly. *See* Delaware Department of Finance, *Delaware Fiscal Notebook* 25 (2008) (showing that Delaware derives only about 5% of its tax revenues from corporate income tax, compared to 30% from personal income tax).<sup>3</sup>

---

<sup>3</sup> Delaware has chosen to give favorable tax treatment to two other types of entities that manage intangible property: headquarters management corporations ("HMCs") and asset management companies ("AMCs"). Both have somewhat more flexibility than IHCs with respect to the range of services they offer, but neither is completely exempt from corporate income tax. HMCs' income is taxable, but they are able to take advantage of tax credits (designed specifically for them) that often reduce their tax to the \$5,000 minimum. *See* Del. Code Ann. Tit. 30, §§ 2061, 2062, 6402. AMCs are entitled to apportion intangibles income based on the location of their "sales" rather than their property or employees; because many

## B. The Add-Back Response

Delaware's corporate tax code embodies the state's considered policy of encouraging companies involved in the management of intellectual and other intangible property to locate in-state. Delaware's efforts in this regard have been successful, and Delaware has become a leading intellectual property center, home to hundreds of IHCs. See, e.g., Donald F. Parsons, *et al.*, *Solving the Mystery of Patentees' "Collective Enthusiasm" for Delaware*, 7 Del. L. Rev. 145 (2004).

Other states have responded in various ways to Delaware's efforts to foster the growth of the intellectual-property management industry. Some states have chosen to compete through constitutionally permissible means by imposing lower taxes or granting tax incentives. Delaware welcomes that sort of friendly competition, which represents the best of the federal system.

Alabama, unfortunately, has chosen a different—and constitutionally impermissible—course. It passed an “add-back” statute, see Ala. Code § 40-18-35(b), that effectively penalizes Alabama taxpayers who choose to locate their intangible property affiliates in Delaware. The Petitioner has explained the add-back statute's operation. It is sufficient for present purposes to note that Alabama's add-back statute is structured such that (1) if an Alabama taxpayer pays royalties to a related corporation *in Delaware*, it will owe Alabama tax on those royalties but (2) if the Alabama company instead pays those royal-

---

of an AMC's customers will be located out-of-state, a significant portion of its income will not be subject to Delaware tax. See *id.* § 1903(b)(7).

ties to a related corporation in Alabama (or Georgia, or some other taxing jurisdiction), it will owe no additional Alabama tax. *See* Pet. 16-17. On its face, therefore, Alabama's add-back statute is—like the similar provisions in 18 other states—an attempt to nullify the benefits that Delaware has chosen to grant as part of its carefully considered tax policy.

## **II. Delaware Is Constitutionally Entitled To Devise And Implement Its Corporate Tax Policies Without Encroachments From Other States.**

Alabama disagrees with Delaware's corporate-tax policy. That much is clear. In its state court briefing, Alabama repeatedly (and pejoratively) referred to Delaware as a "tax-haven state"—presumably because Delaware has chosen not to impose certain taxes on businesses that would be subject to tax in Alabama. *See, e.g.,* Br. of Respondents 37, 45, 70, *Ex parte VFJ Ventures, Inc.*, No. 1070718 (Ala. Sup. Ct.); Br. of Appellants 15, 19, 42, 62, 69, *Surtees v. VFJ Ventures, Inc.*, No. 2060478 (Ala. Ct. Civ. App.). Alabama, of course, is free to disagree with Delaware's tax policy. Indeed, state-to-state disagreements about economic and social policy are the essence of federalism. As "laborator[ies]" of experimentation, individual states are entitled to make the important policy choices that affect their citizens. *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting). Accordingly, within the boundaries of the Constitution and this Court's jurisprudence, Alabama can choose for itself whatever corporate tax policy it wishes.

What Alabama may *not* do is impose its own tax policy on Delaware. As an important corollary to his labor-

atory theorem, Justice Brandeis cautioned that states must make and implement their policy choices—conduct their experiments—“without risk to the rest of the country.” *Id.* Accordingly, this Court has long recognized the fundamental principle that “[n]o State can legislate except with reference to its own jurisdiction” and that “[e]ach State is independent of all others in this particular.” *Bonaparte v. Tax Court*, 104 U.S. 592, 594 (1881). The Court has repeatedly—and in a variety of contexts—reiterated this constitutional prohibition on “extraterritorial” state legislation. *See, e.g., State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 421-22 (2003) (constitutional limitations on state punitive-damages awards); *BMW of North America, Inc. v. Gore*, 517 U.S. 559, 571-72 (1996) (same); *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 821-23 (1985) (constitutional limitations on state choice-of-law rules); *Bigelow v. Virginia*, 421 U.S. 809, 822-23 (1975) (constitutional limitations on state advertising regulations); *New York Life Ins. Co. v. Head*, 234 U.S. 149, 161-65 (1914) (constitutional limitations on state insurance statutes).

Most significantly for present purposes, this Court has consistently enforced the anti-extraterritoriality principle in its dormant Commerce Clause cases. In *Healy v. Beer Institute*, for instance, the Court held that “the Commerce Clause protects against inconsistent legislation arising from the projection of one state regulatory regime into the jurisdiction of another State.” 491 U.S. 324, 336-37 (1989) (citing *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 88-89 (1987)). The *Healy* Court observed that the anti-extraterritoriality principle “reflect[s] the Constitution’s special concern” not only with “the maintenance of a national economic union unfettered by state-imposed limitations on interstate com-

merce,” but also—and more importantly from Delaware’s perspective—with “the autonomy of the individual States within their respective spheres.” *Id.* at 335-36. *Healy* followed more than a half-century of this Court’s Commerce Clause jurisprudence. See, e.g., *Brown-Forman Distillers Corp. v. New York State Liquor Auth.*, 476 U.S. 573, 583-84 (1986) (Commerce Clause prevents one state from “project[ing] its legislation into [other states]” (quoting *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 521 (1935))); *Edgar v. MITE Corp.*, 457 U.S. 624, 642-43 (1982) (Commerce Clause violated where the “practical effect of [a state] regulation is to control [conduct] beyond the boundaries of the state” (quoting *Southern Pac. Co. v. Arizona*, 325 U.S. 761, 775 (1945))).

The Alabama add-back statute’s extraterritoriality is clear. Even on its face, the statute constitutes an effort to impose Alabama’s tax policy beyond its borders and, here, to “project[]” that policy into Delaware. *Healy*, 491 U.S. at 334. In relevant part, the add-back statute provides as follows:

For purposes of computing its taxable income, a corporation shall add back otherwise deductible . . . intangible expenses and costs directly or indirectly paid . . . to . . . one or more related members, except to the extent the corporation shows . . . that the corresponding item of income was in the same taxable year: a. *Subject to a tax based on or measured by the related member’s net income in Alabama or any other state of the United States . . .*

Ala. Code § 40-18-35(b)(1) (emphasis added). Thus, under the statute, an Alabama corporate taxpayer can obtain a business expense deduction for royalty payments to a related company—a deduction to which it is otherwise entitled by law—*only if the payments themselves are taxed in the related company's home state*. If, as here, the state in which the related company is located has chosen *not* to tax royalty income, Alabama's add-back statute is triggered, resulting in additional tax liability for the Alabama taxpayer.

The Alabama courts' opinions below confirm the add-back statute's extraterritorial reach. In the course of attempting to deny that the statute unconstitutionally discriminates against interstate commerce, the Alabama Court of Civil Appeals (whose opinion the Alabama Supreme Court adopted as its own) observed—with emphasis—that “[t]he subject-to-tax exception of Alabama's add-back statute applies when the related member's income is taxed ‘in Alabama or any other State of the United States.’” Pet. App. 62a (quoting Ala. Code § 40-18-35(b)(1)). Thus, the court said, “the subject-to-tax exception challenged by VFJ is implicated *regardless of which state imposes a tax* on the related member's income.” *Id.* (emphasis added). But this is precisely the problem with Alabama's add-back statute. The related member's home state *must* “impose[] a tax” on the related member's royalty income. If it chooses not to, the Alabama taxpayer will suffer the add-back consequences.

The likely impact is clear: Alabama's add-back statute will “discourage[] Alabama corporations from entering into royalty agreements with related members located in [non-taxing] States” like Delaware or, for that

matter, “from setting up related members in non-taxing States” like Delaware in the first place. Pet. 19. For a state like Delaware, the disincentive created by the add-back is substantial. Were Lee and Wrangler located in a taxing state rather than Delaware, the Petitioner’s “taxes in Alabama would decrease by about \$1 million” for the 2001 tax year alone. Pet. 22. (Of course, the Petitioner’s Alabama tax liability would also decrease if Delaware would “change[] its laws to tax the royalty payments made” to in-state companies like Lee and Wrangler. *Id.*) Multiply the disincentive created by Alabama’s add-back statute by 19—the number of states that currently have such statutes (*see* Pet. App. 12a n.3)—and the consequences for Delaware’s carefully considered and longstanding tax policies are dire.

Alabama and the other add-back states are picking winners and losers based on their own view of Delaware’s and other states’ tax policies. These states should not be permitted to undermine Delaware’s policy judgments by imposing their own preferences through impermissible extraterritorial legislation.

### **III. This Court Should Resolve The Add-Back Issue Now.**

The Petitioner has explained why prompt review of the Alabama Supreme Court’s decision is important both to corporate taxpayers and to the 19 states that have enacted add-back statutes. *See* Pet. 3-4, 25-31. The taxpayers’ interest in a quick decision is clear: They are presently being subjected to substantial taxes under statutes that they contend are unconstitutional. The taxing states’ interest in speedy resolution is just as significant. Should this Court eventually hold that add-back statutes

like Alabama's violate the Commerce Clause, taxing states will likely have to pay out refunds on a retrospective basis. See, e.g., *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 31-36 (1990). "The longer States continue enforcing add-back statutes, the more States may eventually be forced to refund." Pet. 30. These "enormous potential refund liabilities" could wreak havoc with taxing states' budgetary assumptions. *Id.* Thus, as the Petitioner contends, "prompt resolution of this issue would benefit not only taxpayers, but also the States that have adopted [add-back] statutes and other States that may follow suit." *Id.*

While Delaware is differently situated, it too needs clarity now. Should this Court wait to address the constitutional question that these add-back statutes present, Delaware could well suffer irreparable harm in the meantime. As already explained, Delaware's policy decisions have for years successfully attracted businesses with, among other things, comparatively lower taxes. Should this Court allow the Alabama Supreme Court's decision to stand—thereby approving, at least on an interim basis, Alabama's add-back policy—companies presently based in Delaware could choose to organize elsewhere. Likewise, companies may decide that the benefits of Delaware's tax policy are too uncertain to justify organizing in Delaware in the first instance.

Surely the Petitioner, for example, would prefer to see Lee and Wrangler located in Alabama (or some other taxing state) to relieve its add-back tax obligation. Because, like a number of other add-back states, Alabama does not impose an add-back penalty on the portion of royalty-related payments on which the recipient actually pays *any* tax, the rational business decision would be to

relocate Lee and Wrangler out of Delaware to the state that imposes the smallest tax greater than zero. Especially in light of the current volatility of the national economy, Delaware's concerns about losing a significant sector of its corporate base are warranted, as companies may choose to relocate rather than stay in Delaware while this Court allows the add-back issue to percolate.

It is unlikely that even a favorable decision in some later case could undo the damage. The companies that had relocated to other states, for instance, might not all return to Delaware. Even if a number of them did, Delaware would have lost the benefit of having those companies in-state in the interim. Most troublingly, by the time this Court stepped in to remedy the situation, Delaware may already have been forced, as a result of the extraterritorial reach of these add-back statutes, to alter its own corporate tax policy in fundamental ways—through nominal taxes aimed at thwarting add-back statutes, tax credits, or otherwise. Because this Court's dormant Commerce Clause jurisprudence recognizes that this sort of interstate back and forth does lasting damage to the federal union, the Court should address the add-back issue now.

Clearly, Delaware has a position on the merits here: It believes that add-back statutes like Alabama's (1) impermissibly reach across state borders in an effort to influence Delaware tax policy and (2) inherently discriminate against interstate commerce in ways prohibited by this Court's case law. Having said that, Delaware's current concern is that the Court resolve the add-back issue—one way or the other—imminently. For reasons already explained, an affirmance would prejudice Delaware's historical, and successful, policy judgments. Nev-

ertheless, an affirmance would permit Delaware to go forward with some level of certainty, knowing that it would need to account for the add-back phenomenon. As matters stand now, the add-back issue is in a state of legal limbo—to the detriment of Delaware's fiscal policy-makers and Delaware's businesses, neither of which can adequately plan for the future.

### CONCLUSION

This Court should grant the petition for certiorari.

Respectfully submitted,

RICHARD S. GEBELEIN

*Chief Deputy*

*Attorney General*

LAWRENCE W. LEWIS\*

*State Solicitor*

JENNIFER D. OLIVA

*Deputy State Solicitor*

DEPARTMENT OF JUSTICE

820 NORTH FRENCH ST.

WILMINGTON, DE 19801

(302) 577-8400

*\* Counsel of Record*

Counsel for *Amicus Curiae*

121

(4)

No. 08-916

Supreme Court, U.S.  
FILED

FEB 20 2009

OFFICE OF THE CLERK

IN THE  
**Supreme Court of the United States**

VFJ VENTURES, INC., F/K/A VF JEANSWEAR, INC.,

*Petitioner,*

v.

G. THOMAS SURTEES, IN HIS OFFICIAL CAPACITY AS  
COMMISSIONER OF THE DEPARTMENT OF REVENUE  
FOR THE STATE OF ALABAMA,  
AND THE ALABAMA DEPARTMENT OF REVENUE,

*Respondents.*

On Petition for Writ of Certiorari to the  
Supreme Court of Alabama

BRIEF OF  
INSTITUTE FOR PROFESSIONALS  
IN TAXATION  
AS *AMICUS CURIAE*  
IN SUPPORT OF PETITIONER

CASS D. VICKERS  
(*Counsel of Record*)

Institute for  
Professionals  
in Taxation

1200 Abernathy Road NE  
Atlanta, GA 30328  
(850) 907-0692

DONALD M. GRISWOLD  
Reed Smith LLP  
1301 K Street N.W.  
Washington DC 20005  
(202) 414-9200

SARA A. LIMA  
Reed Smith LLP  
1650 Market Street  
Philadelphia, PA 19103  
(215) 851-8100

## TABLE OF CONTENTS

|   | Page |
|---|------|
| TABLE OF AUTHORITIES .....  | iii  |
| INTEREST OF THE <i>AMICUS CURIAE</i> .....  | 1    |
| SUMMARY OF ARGUMENT .....   | 2    |
| REASONS WHY THE WRIT SHOULD BE<br>GRANTED .....   | 3    |
| I. IMPORTANT CONSTITUTIONAL QUESTIONS<br>WILL GO UNRESOLVED UNLESS<br>THE WRIT IS GRANTED.....                              | 3    |
| A. Alabama Has Undermined the Integrity of<br>Our System of Interstate Commerce by<br>Unfairly Apportioning Income.....     | 4    |
| 1. The Commerce Clause Protects Our<br>National Free-Trade Zone from<br>Extraterritorial Taxation by States .....           | 5    |
| 2. The Statute Is <i>Per Se</i> Invalid Because,<br>on Its Face, Its Operation is Triggered by<br>Out-of-State Events ..... | 7    |
| 3. The Statute Invalidly Aims to Tax Income<br>Attributable to Other States .....   | 9    |

## TABLE OF CONTENTS (continued)

|   | Page |
|---|------|
| B. Alabama Has Denied Due Process of Law to<br>VFJ and Other Corporations .....   | 13   |
| 1. Due Process Protects Corporate Persons<br>from State Taxation of Values Not<br>Rationally Related to that State .....  | 13   |
| 2. The Statute Constitutes a Facial Denial of<br>Due Process Because It Is Qualitatively<br>Irrational to Determine Any Corporation's<br>In-State Values Based on Another State's<br>Tax Policies ..... | 15   |
| II. THE NEED FOR REVIEW IS URGENT .....   | 18   |
| A. The Proliferation of Similar Statutes Around<br>the Country, and Continuing Uncertainty<br>Regarding Their Validity, Impose Onerous<br>Compliance Costs on America's Businesses..                    | 18   |
| B. America's Businesses Will Never Be Made<br>Whole, But Prompt Resolution Will Mitigate<br>the Damages.....  | 22   |
| CONCLUSION.....   | 24   |

## TABLE OF AUTHORITIES

## CASES

|  | Page(s) |
|--|---------|
| <i>American Tel. &amp; Tel. Co. v. Wisc. Dep't. of Rev.</i> ,<br>422 N.W.2d 629 (Wisc. Ct. App. 1987).....                         | 10      |
| <i>Boston Stock Exch. v. State Tax Comm'n</i> ,<br>429 U.S. 318 (1977) .....   | 6       |
| <i>Caterpillar Tractor Co. v. Dep't. of Rev.</i> ,<br>8 Or. Tax 236 (Or. T.C. 1979).....   | 10      |
| <i>Complete Auto Transit, Inc. v. Brady</i> ,<br>430 U.S. 274 (1977) .....   | 5       |
| <i>Container Corp. of Am. v. Franchise Tax Bd.</i> ,<br>463 U.S. 159 (1983) .....  | 7, 8, 9 |
| <i>Covington &amp; Lexington Tpk. Rd. Co. v. Sandford</i> ,<br>164 U.S. 578 (1896) .....   | 14      |
| <i>Ex parte Surtees (Vulcan Lands, Inc. v. Surtees)</i> ,<br>Nos. 1070386, 1070399, 2008 WL 4369259 (Ala.<br>Sept. 26, 2008) ..... | 23      |
| <i>Exxon Corp. v. Wis. Dep't. of Revenue</i> ,<br>447 U.S. 207 (1980) .....  | 14, 18  |
| <i>First Nat'l Bank v. Bellotti</i> ,<br>435 U.S. 765 (1978) .....   | 14      |
| <i>Geoffrey Inc. v. S.C. Tax Comm'n.</i> ,<br>437 S.E.2d 13 (S.C. 1993).....   | 10      |

# TABLE OF AUTHORITIES

## (continued)

|  | Page(s)   |
|--|-----------|
| <i>Hans Rees' Sons, Inc. v. North Carolina</i> ,<br>283 U.S. 123 (1931) .....                            | 17        |
| <i>Hunt-Wesson, Inc. v. Franchise Tax Bd.</i> ,<br>528 U.S. 458 (2000) .....                             | 8, 9      |
| <i>Lanco, Inc. v. Director, Div. of Taxation</i> ,<br>21 N.J. Tax 200 (N.J. Tax Ct. 2003) .....          | 10        |
| <i>Luckenbach S.S. Co. v. Franchise Tax Bd.</i> ,<br>33 Cal. Rptr. 544 (Cal. Ct. App. 1963) .....        | 12        |
| <i>McKesson Corp. v. Division of Alcoholic Beverages<br/>&amp; Tobacco</i> ,<br>496 U.S. 18 (1990) ..... | 23        |
| <i>MeadWestvaco Corp. v. Ill. Dep't of Revenue</i> ,<br>128 S. Ct. 1498 (2008) .....                     | 9         |
| <i>Mobil Oil Corp. v. Comm'r of Taxes of Vt.</i> ,<br>445 U.S. 425 (1980) .....                          | 14, 18    |
| <i>Moorman Mfg. Co. v. Bair</i> ,<br>437 U.S. 267 (1978) .....   | 14, 18    |
| <i>New Energy Co. of Ind. v. Limbach</i> ,<br>486 U.S. 269 (1988) .....                                  | 6         |
| <i>Norfolk &amp; W. Ry. Co. v Mo. State Tax Comm'n</i> ,<br>390 U.S. 317 (1968) .....                    | 8, 14, 18 |

# TABLE OF AUTHORITIES

## (continued)

### Page(s)

|   |            |
|---|------------|
| <i>Northwestern States Portland Cement Co. v. Minnesota,</i><br>358 U.S. 450 (1959) .....                         | 5          |
| <i>Oklahoma Tax Comm'n v. Jefferson Lines, Inc.,</i><br>514 U.S. 175 (1995) .....                                 | 10         |
| <i>Quill Corp. v. North Dakota,</i><br>504 U.S. 298 (1992) .....  | 5, 14      |
| <i>Santa Clara County v. Southern Pacific R.R. Co.,</i><br>118 U.S. 394 (1886) .....                              | 14         |
| <i>South Cent. Bell Tel. Co. v. Alabama,</i><br>526 U.S. 160 (1999) .....   | 24         |
| <i>Surtees v. VFJ Ventures, Inc.,</i><br>No. 2060478, 2008 WL 344118 (Ala. Civ. App.<br>Feb. 8, 2008) .....       | 11, 17, 22 |
| <i>Trinova Corp. v. Mich. Dep't of Treasury,</i><br>498 U.S. 358 (1991) .....                                     | 8, 14      |
| <i>Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue,</i><br>483 U.S. 232 (1987) .....                      | 5          |
| <i>VFJ Ventures, Inc. v. Surtees,</i><br>No. CV-03-3172 (Cir. Ct. Montgomery County,<br>Ala. Jan. 24, 2007) ..... | 11         |

**TABLE OF AUTHORITIES**  
(continued)

**Page(s)**

|   |    |
|---|----|
| <i>Vulcan Lands, Inc. v. Surtees</i> ,<br>No. 2060607, 2007 WL 4215046 (Ala. Civ. App.,<br>Nov. 30, 2007) ..... | 23 |
|---|----|

**CONSTITUTIONAL PROVISIONS**

|                                     |       |
|-------------------------------------|-------|
| U.S. Const. art. I, § 8, cl. 3..... | 3     |
| U.S. Const. amend. XIV .....        | 3, 13 |

**STATUTES AND ADMINISTRATIVE  
MATERIAL**

|  |           |
|--|-----------|
| Ala. Code § 40-18-33 .....               | 15        |
| Ala. Code § 40-18-35(b) .....            | 4, 13, 16 |
| Ala. Code §40-27-1 .....                 | 11        |
| Ark. Code Ann. § 26-51-423(g) .....      | 13, 18    |
| Conn. Gen. Stat. § 12-218c) .....        | 13, 18    |
| D.C. Code Ann. § 47-1803.03(a)(19) ..... | 13, 18    |
| Ga. Code Ann. § 48-7-28.3(b)(1)(K) ..... | 13, 18    |
| 35 Ill. Comp. Stat. 5/203(b)(E-12) ..... | 13, 18    |
| 35 Ill. Comp. Stat. 5/203(b)(E-13) ..... | 13, 18    |
| Ind. Code Ann. § 6-3-1-3.5(b)(9) .....   | 13, 18    |

**TABLE OF AUTHORITIES**  
(continued)

|  | <b>Page(s)</b> |
|--|----------------|
| Ind. Code Ann. § 6-3-2-20 .....                                | 13, 18         |
| Ky. Rev. Stat. Ann. § 141.205.....                             | 13, 18         |
| Md. Code Ann., Tax-Gen. § 10-306.1 .....                       | 13, 18         |
| Mass. Gen. Laws Ann. ch. 63, § 31I.....                        | 13, 18         |
| Mass. Gen. Laws Ann. ch. 63, § 31J.....                        | 13, 18         |
| Mich. Comp. Laws § 208.1201(2)(f).....                         | 13, 18         |
| H.B. 660, S.B. 753, 2005 Leg., 84th Sess. (Minn.<br>2005)..... | 19             |
| Miss. Code Ann. § 27-7-17(2).....                              | 13, 18         |
| N.J. Stat. Ann. § 54:10A-4.....                                | 13, 18         |
| N.J. Stat. Ann. § 54:10A-4.4.....                              | 13, 18         |
| N.Y. Tax Law § 208.9(o) .....                                  | 13, 18         |
| N.C. Gen. Stat. §105-130.7A .....                              | 13, 18         |
| Ohio Rev. Code Ann. § 5733.042); .....                         | 13, 18         |
| Or. Admin. R. 150-314.295 .....                                | 13, 18         |
| H.B. 518, 2005 Gen. Assem., Reg. Sess. (Pa. 2005)              | 19             |
| R.I. Gen. Laws § 44-11-11(f) .....                             | 13, 18         |

## TABLE OF AUTHORITIES (continued)

|                                      | Page(s) |
|--------------------------------------|---------|
| S.C. Code Ann. § 12-6-1130 .....     | 13, 18  |
| Tenn. Code Ann. § 67-4-2006(b) ..... | 13, 18  |
| Tenn. Code Ann. § 67-4-2006(d) ..... | 13, 18  |
| Va. Code Ann. § 58.1-402(B).....     | 13, 18  |
| Wis. Stat. § 71.26(2)(a) .....       | 13, 18  |
| Wis. Stat. § 71.80(23).....          | 13, 18  |

## RULE

|                        |   |
|------------------------|---|
| Sup. Ct. R. 37.6 ..... | 1 |
|------------------------|---|

## OTHER AUTHORITIES

|  |    |
|--|----|
| Brannon P. Denning, <i>Confederation-Era<br/>Discrimination Against Interstate Commerce and<br/>the Legitimacy of the Dormant Commerce Clause<br/>Doctrine</i> , 94 KY. L.J. 37, 53 (2005/2006)..... | 19 |
| The Federalist (Clinton Rossiter ed., 1961) .....  | 6  |
| Joe Garrett and Kelly W. Smith, <i>Add-Back Statutes:<br/>Where Do We Go From Here?</i> , Presentation at<br>2005 SEATA Conference (July 12, 2005).....  | 19 |

# TABLE OF AUTHORITIES

## (continued)

|   | Page(s) |
|---|---------|
| Sanjay Gupta and Lillian Mills, <i>Does Disconformity in State Corporate Income Tax Systems Affect Compliance Cost Burdens?</i> NATIONAL TAX JOURNAL 56:2 (June 2003).....                    | 21      |
| 1 Jerome R. Hellerstein & Walter Hellerstein, STATE TAXATION (3d. ed. 2008).....  | 12      |
| J. Scott Moody, Wendy Warcholik, & Scott A. Hodge, <i>The Rising Cost of Complying with the Federal Income Tax</i> , TAX FOUNDATION SPECIAL REPORT (Dec. 2005) .....                          | 20      |
| Multistate Tax Compact, <a href="http://www.mtc.gov">http://www.mtc.gov</a> .....   | 11      |
| Press Release from California Controller John Chiang, Chiang Announces Payment Delays to Manage Cash Crisis (January 16, 2009) .....  | 23      |
| Michael S. Schadewald, <i>Deducting Related-Party Interest and Intangible Expenses</i> (2005).....  | 19      |
| Daniel Shaviro, <i>An Economic and Political Look at Federalism in Taxation</i> , 90 MICH. L. REV. 895 (1992) .....   | 20      |
| E. Kendrick Smith and Matt Cristy, <i>Georgia Gets A Grasp On Passive Investment Companies: New Addback Statute Reaches Intangible and Interest Income Flowing From The State</i> (2005)..... | 19      |

TABLE OF AUTHORITIES  
(continued)

|  | Page(s) |
|--|---------|
| Laurence H. Tribe, AMERICAN CONSTITUTIONAL LAW<br>(3d. ed.) (2000) .....   | 7       |
| Andres Vallejo and Scott M. Reiber, <i>Predicting the<br/>Remedy for Unconstitutional State Taxes: A<br/>Review of Recent Decisions Under the McKesson<br/>Framework</i> , TAX MANAGEMENT MULTISTATE TAX<br>REPORT, Vol. 16, No. 1 ..... | 23      |
| Virginia Pub. Doc. Rul. No. 91-258 (10/28/1991) ....   | 10      |

No. 08-916

IN THE  
**Supreme Court of the United States**

---

VFJ VENTURES, INC., F/K/A VF JEANSWEAR,  
INC.,

*Petitioner,*

v.

G. THOMAS SURTEES, IN HIS OFFICIAL CAPACITY AS  
COMMISSIONER OF THE DEPARTMENT OF REVENUE  
FOR THE STATE OF ALABAMA,  
AND THE ALABAMA DEPARTMENT OF REVENUE,

*Respondents.*

---

On Petition for Writ of Certiorari to the  
Supreme Court of Alabama

---

BRIEF OF  
INSTITUTE FOR PROFESSIONALS  
IN TAXATION  
AS *AMICUS CURIAE*  
IN SUPPORT OF PETITIONER

---

INTEREST OF THE *AMICUS CURIAE*

This brief *amicus curiae* in support of  
Petitioner, VFJ Ventures, Inc., f/k/a VF Jeanswear,  
Inc. ("VFJ"), is filed on behalf of the Institute for  
Professionals in Taxation ("IPT").<sup>1</sup> IPT is a non-

---

<sup>1</sup>Pursuant to Sup. Ct. Rule 37.6, *amicus* Institute for

profit educational organization that seeks to promote uniform and equitable administration of state taxes. IPT has more than 4,500 members representing more than 1,400 businesses across the United States and in Canada. Represented within IPT's membership are numerous small businesses and most of the Fortune 500 companies spanning all major industries. IPT members represent some 387 corporations doing business in Alabama and states with add-back statutes that are similar to the Alabama statute at issue here.

## SUMMARY OF ARGUMENT

Hundreds of America's major businesses have had their due process rights violated by Alabama, causing them significant harm for which they can never be fully compensated. Therefore, the Court should grant VFJ's *cert* petition now and put an end to the violation, so that the damage can be mitigated. The Alabama add-back statute challenged by VFJ denies due process to businesses because it determines a corporation's Alabama tax base by reference to a factor that has no rational relationship to the corporation's in-state values – the tax policies of other states.

The past eight years have seen a proliferation of similar add-back statutes around the country. Today, twenty other states and the District of

---

Professionals in Taxation states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, or counsel, has made a monetary contribution to the preparation or submission of this brief. Both parties have consented to the submission of this brief in letters filed with the Clerk.

Columbia also have add-back statutes that suffer from constitutional defects, and more states have recently considered adoption of such measures. This accelerating trend toward state use of add-back statutes to tax extraterritorial values, in violation of corporate taxpayers' due process rights, must be stopped now.

The danger and the damage are not limited to the serious harm that is specific to America's businesses, for add-back statutes also undermine another national interest of preeminent importance: they authorize a state to tax income that is unquestionably attributable to other states. Such extraterritorial taxation has long been recognized by this Court to be a pernicious threat to the very foundation of our economic cohesion as one nation – the maintenance and protection of a single nationwide free-trade zone that the Commerce Clause has long been understood to guarantee. The writ should be granted.

## REASONS WHY THE WRIT SHOULD BE GRANTED

### I. IMPORTANT CONSTITUTIONAL QUESTIONS WILL GO UNRESOLVED UNLESS THE WRIT IS GRANTED

The apportionment question raised by VFJ's *cert* petition – how much income is attributable to and thus taxable by the state? – implicates both the Commerce Clause of the United States Constitution and the Due Process Clause of the Fourteenth Amendment.<sup>2</sup>

---

<sup>2</sup> U.S. Const. art. I, §8, cl. 3; U.S. Const. amend. XIV.

### **A. Alabama Has Undermined the Integrity of Our System of Interstate Commerce by Unfairly Apportioning Income**

The Alabama add-back statute enlarges the portion of a taxpayer's income attributed to Alabama by the amount of a taxpayer's expenses for royalties and interest paid to an affiliate, except "to the extent ... that the corresponding item of [royalty and interest] income was .... subject to tax ... in Alabama or any other state."<sup>3</sup>

This statute, on its face, raises a fundamental issue of constitutional law: Can a state tax income not properly attributable to it, simply because no other state has chosen to tax it? More specifically, when only a certain portion of a company's income is concededly subject to tax by a state, does the United States Constitution permit that state to enlarge the share it taxes by an amount not properly attributable to it, simply by reason of the taxpayer's payments to an affiliate that is not taxed on the corresponding income elsewhere?

The add-back adjustment in question operates wholly without regard to the quantum or portion of VFJ's multistate business activities in Alabama; it was triggered by VFJ's payment of royalties to an out-of-state affiliate located in a jurisdiction that did not tax the affiliate's royalty income. Identical payments would have been deductible under the Alabama statute if made to an affiliate in Alabama or in another jurisdiction that taxes such royalty income on a separate return. The issue considered here thus is of the statute's facial invalidity under

---

<sup>3</sup> Ala. Code §40-18-35(b)(1).

the fair apportionment requirement of the Commerce Clause, in particular whether that command tolerates an apportionment scheme which entirely disregards any taxpayer's business activities in Alabama and looks instead to the tax treatment of an affiliated entity's income in another jurisdiction.

### 1. The Commerce Clause Protects Our National Free-Trade Zone from Extraterritorial Taxation by States

A tax on multistate income must be nondiscriminatory and "properly apportioned to local activities within the taxing State . . . ." <sup>4</sup> The Court has linked the requirements for nondiscrimination and fair apportionment, observing that "[a] tax that unfairly apportions income from other states is a form of discrimination against interstate commerce." <sup>5</sup> It has said that those two dictates work together to "prohibit taxes that pass an unfair share of the tax burden onto interstate commerce." <sup>6</sup> Among the constitutional objectives served by the fair apportionment and nondiscrimination requirements as limitations on state taxing powers is that of maintaining an open economy. <sup>7</sup>

The Commerce Clause assures a national marketplace unfettered by state revenue measures that would interfere with transactions in interstate

---

<sup>4</sup> *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 495 (1959).

<sup>5</sup> *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 247 (1987).

<sup>6</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 (1992).

<sup>7</sup> *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 289 (1978) (Powell, J., dissenting); see also, *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

commerce.<sup>8</sup> Exemplary of offending measures is the example Alexander Hamilton gave in *The Federalist No. 7* of New York laying duties on imports that would be paid by residents of Connecticut and New Jersey, as to which the author rhetorically asked: "Would Connecticut and New Jersey long submit to be taxed by New York for her exclusive benefit?"<sup>9</sup> Hamilton also argued in *The Federalist No. 11* for "an unrestrained intercourse between the States," pointing out that the alternative would be that commercial "intercourse [among the states] would be fettered, interrupted and narrowed by a multiplicity of causes," when what is needed instead is a "unity of commercial, as well as political interests."<sup>10</sup>

The Alabama add-back scheme is precisely one such sub-national political interference with the free flow of commercial transactions among the states. On its face, the statute arrogates taxable income to Alabama simply because other states have chosen not to tax it, and thus in practice the statute serves to interrupt interstate commerce by discouraging corporations subject to Alabama tax from doing business in states whose tax policies do not coincide with those of Alabama.<sup>11</sup> The statute has the kind of narrowing, or channeling effect, of which Mr.

---

<sup>8</sup> See *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 329 (1977).

<sup>9</sup> *The Federalist No. 7*, at 63 (Alexander Hamilton) (Clinton Rossiter ed., 1961).

<sup>10</sup> *The Federalist No. 11*, at 89-90 (Alexander Hamilton) (Clinton Rossiter ed., 1961).

<sup>11</sup> Alabama's attempt to clothe the statute with facial neutrality by foregoing the add-back adjustment for interstate transactions with some, but not other, states is unavailing. See *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 274-75 (1988) and decisions cited there rejecting such alliances of reciprocity.

Hamilton wrote. Allowing such measures to stand would invite the spider-webbing of interstate commerce with a "multiplicity" of provincial causes, a result that is pernicious to our economic freedoms as a nation.

## 2. The Statute Is *Per Se* Invalid Because, on Its Face, Its Operation is Triggered by Out-of-State Events

It is unlawful for Alabama to tie Alabama tax liability to matters that occur solely in other states. A respected constitutional scholar has noted that the Court's precedents have established "a virtually *per se* rule of invalidity for extraterritorial state regulations," including "laws whose operation is triggered by out-of-state events."<sup>12</sup> The Alabama add-back statute, which triggers an increase in an in-state royalty payor's tax liability based upon an out-of-state event — taxation or non-taxation of the corresponding income recipient elsewhere — is just such a law. Consequently, the Alabama add-back statute is *per se* invalid under the Commerce Clause.

Furthermore, an expense disallowance law "whose operation is triggered by out-of-state events" abandons the necessary rational connection between the taxpayer's in-state activity and its tax base in that state. In response to an earlier contention that the Michigan single business tax failed the "external consistency" test under the Commerce Clause,<sup>13</sup> the

---

<sup>12</sup> Laurence H. Tribe, *AMERICAN CONSTITUTIONAL LAW*, § 7-8 at 1064, (3d. ed.) 2000.

<sup>13</sup> In *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983), the Court held that fair apportionment demands external consistency: apportionment must "actually

Court framed the inquiry as whether "there is no rational relationship between the tax base measure attributed to the State and the contribution of Michigan business activity."<sup>14</sup> Fair apportionment demands the presence of such a rational relationship. A statute attributing income to a taxing jurisdiction when there is no reasonable connection between that income and the in-state business activities of the taxpayer is irrational, and therefore necessarily fails to "fairly apportion" income to that state.

While some arrangements may need proof that the statute works an irrational and therefore unfair result, others may be judged irrational on their face.<sup>15</sup> In *Hunt-Wesson*,<sup>16</sup> the Court struck as invalid on its face a California statute disallowing a deduction for interest expense in an amount equal to "certain out-of-state income ... that the state could not otherwise tax."<sup>17</sup> The Court did not require proof of the statute's impact in practical application, for the statute failed on its face to "actually reflect a reasonable sense of how income is generated" – the dictate of the external consistency test.<sup>18</sup>

The same may be said of the Alabama add-back statute. On its face, the statute determines the deductibility of a taxpayer's royalty expenses on

---

reflect a reasonable sense of how income is generated." *Id.*

<sup>14</sup> *Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358, 380 (1991).

<sup>15</sup> See *Norfolk & W. Ry. Co. v. Mo. State Tax Comm'n*, 390 U.S. 317, 325 (1968) ("Any formula used must bear a rational relationship, both on its face and in its application, to property values connected with the taxing State").

<sup>16</sup> *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000).

<sup>17</sup> *Id.*, at 460.

<sup>18</sup> *Id.*, at 466 (quoting *Container Corp.*, 463 U.S. at 169.)

whether the corresponding royalty income is taxed elsewhere. This determinative factor does not “actually reflect a sense of how [the] income is generated,”<sup>19</sup> so the Alabama add-back statute is unconstitutional on its face.

It may be worth mentioning here another way in which the statute is irrational and facially distortive: The statute adds back the royalty payments as “income” to VFJ without any offset for the expenses of generating that income. Were Alabama to tax the income in the hands of the parties that earned it (Lee and Wrangler), that tax base amount would be reduced by those corporations’ expenses. Moreover, the amount of their income subject to tax in Alabama would be calculated by reference to Lee’s and Wrangler’s apportionment factors, not VFJ’s. The Court has not ruled but recently commented upon the possible constitutional dimensions of such a disconnect.<sup>20</sup>

### 3. The Statute Invalidly Aims to Tax Income Attributable to Other States

The Commerce Clause “external consistency” test articulated in *Container*<sup>21</sup> was later explained by the Court to encompass more than the rationality concern addressed above. In *Jefferson Lines*, the Court described this additional concern as follows:

External consistency . . . looks . . . to the economic justification for the State’s claim

---

<sup>19</sup> *Id.*

<sup>20</sup> See *MeadWestvaco Corp. v. Ill. Dep’t of Revenue*, 128 S.Ct. 1498, 1509, n.4 (2008).

<sup>21</sup> *Container Corp.*, 463 U.S. at 169.

upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to activity within the taxing State.<sup>22</sup>

A common economic justification for add-back statutes is that they enable the state to tax certain items of income that go untaxed by any state — amounts that have been pejoratively characterized in this and other contexts as “nowhere income.”<sup>23</sup> Such legislative justifications are invalid, for the targeted income is in fact “somewhere,” even when the jurisdictions to which these amounts are properly attributable are simply not taxing it for tax policy or other reasons. A decision by one state not to tax is no justification for another state to enlarge its tax base by the amount of the non-taxing jurisdiction's attributable portion of the company's multistate income.

The Alabama statute is an aggravated transgression of the constitutional fair apportionment requirement for the reason that its very object is to enlarge the Alabama tax base beyond the income that is properly attributed to

---

<sup>22</sup> *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995).

<sup>23</sup> See, e.g., *Geoffrey Inc. v. S.C. Tax Comm'n.*, 437 S.E.2d 13, 17, n. 1 (S.C. 1993) (“The net effect of this corporate structure [payment of royalties to an out-of-state affiliate] has been the production of ‘nowhere’ income . . .”). See also, *American Tel. & Tel. Co. v. Wisc. Dept. of Rev.*, 422 N.W.2d 629, 635 n. 16 (Wisc. Ct. App. 1987); *Lanco, Inc. v. Dir., Div. of Taxation*, 21 N.J. Tax 200 (N.J. Tax Ct. 2003), *rev'd*, 879 A.2d 1234 (N.J. Super. App. Div. 2005), *aff'd*, 908 A.2d 176 (N.J. 2006); *Caterpillar Tractor Co. v. Dept. of Rev.*, 8 Or. Tax 236 (Or. T.C. 1979); Virginia Pub. Doc. Rul. No. 91-258 (10/28/1991).

Alabama. Lee and Wrangler are headquartered in Delaware and have their offices and all their employees there.<sup>24</sup> From that location they do business, not just with VFJ but with unrelated third parties as well.<sup>25</sup> VFJ's payment of royalties to Lee and Wrangler were determined by the lower courts to be ordinary and necessary expenses of doing business,<sup>26</sup> and the corresponding royalty income was received by Lee and Wrangler.

If the State of Alabama were taxing Lee and Wrangler directly (it is not), Alabama would attribute none of this royalty income to Alabama because the State, through its adoption of the Multistate Tax Compact,<sup>27</sup> attributes receipts from the sale of intangibles to the state where the greater proportion of income-producing activity occurs – Delaware, for Lee and Wrangler.<sup>28</sup> Thus, for apportionment formula purposes, Alabama recognizes that the receipts from the royalty transactions here are properly identifiable with Delaware, not Alabama.

The Alabama add-back statute, however, reflects the legislature's discontent with these normal rules for attributing such royalty income to affiliates over which the State does not (or cannot)

---

<sup>24</sup> See *VFJ Ventures, Inc. v. Surtees*, No. CV-03-3172 (Cir. Ct. Montgomery County, Ala. Jan. 24, 2007); App. to Pet. Cert. 69a.

<sup>25</sup> *Id.*

<sup>26</sup> See *Surtees v. VFJ Ventures, Inc.*, No. 2060478, 2008 WL 344118, at \*11 (Ala. Civ. App. Feb. 8, 2008); App. to Pet. Cert. at 28a.

<sup>27</sup> See §17 of the Multistate Tax Compact, available at <http://www.mtc.gov>.

<sup>28</sup> See Ala. Code §40-27-1; see also §17 of the Multistate Tax Compact.

assert taxing jurisdiction. In such a case, the add-back statute disregards the usual attribution of the receipts to Delaware. Sensing a revenue opportunity created by Delaware's tax policy (exemption of this type of royalty income from Delaware taxation), Alabama uses the add-back statute to shift that Delaware income into the Alabama tax base.

In this very real sense, then, the Alabama statute is intentionally distortive. Rather than making an effort to "reasonably" reflect the geographic location where the subject income is earned, it does precisely the opposite. It purposefully eschews that attribution — solely because the jurisdiction with which the income is rationally identifiable has chosen not to tax it. The very object, the only object, of the add-back is income fairly attributable to a jurisdiction other than Alabama. If that other jurisdiction elects to tax the income, the add-back statute stands idle; if that other jurisdiction elects not to tax the income, the add-back statute inflates the taxpayer's Alabama tax base. As one eminent scholar has observed of such practices, however, "States do not acquire the power to tax income earned elsewhere merely because the income is not taxable where it is earned."<sup>29</sup> The intentional character of this distortion of income is plain on the statute's face.

As a measure which forsakes any effort to attribute income based on a rational view of where the income is earned, the Alabama add-back statute

---

<sup>29</sup> 1 Jerome R. Hellerstein & Walter Hellerstein, *STATE TAXATION*, ¶ 10.03[5], at 10-33 (3d. ed. 2000) (discussing *Luckenbach S.S. Co. v. Franchise Tax Bd.*, 33 Cal. Rptr. 544 (Cal. Ct. App. 1963), *appeal dismissed*, 377 U.S. 215 (1964)).

falls short on its face of the constitutional demand for fair apportionment. It reveals patent overreaching of the taxing jurisdiction's boundaries simply because another jurisdiction has chosen not to tax. The Court should grant the Petition for Certiorari in order to safeguard the guarantee of fair apportionment that income attribution be based on a rational effort to relate the income to the taxpayer's business activities in the taxing state.

### **B. Alabama Has Denied Due Process of Law to VFJ and Other Corporations**

Hundreds of major corporations and perhaps thousands of smaller ones, including businesses represented in IPT's membership, are currently being deprived of their due process rights by the State of Alabama and twenty-one other jurisdictions that have adopted similar add-back statutes.<sup>30</sup> Even though a split of state high court authority has not yet developed on the issues presented here, the Court should grant the writ now because these due process violations are serious, widespread, and accelerating.

#### **1. Due Process Protects Corporate Persons from State Taxation of Values Not Rationally Related to that State**

The Due Process Clause of the Fourteenth Amendment to the United States Constitution provides: "nor shall any State deprive any person of life, liberty, or property, without due process of law."<sup>31</sup> The Constitution guarantees due process to

---

<sup>30</sup> See statutes cited *infra* n. 43.

<sup>31</sup> U.S. Const. amend. XIV, §1

corporate persons as well as natural persons,<sup>32</sup> aiming in both contexts to ensure the maintenance of "traditional notions of fair play and substantial justice."<sup>33</sup> Taxation, of course, deprives a corporate person of its property, so the question with which this case is centrally concerned – how much of a corporate person's income is properly attributable to (and thus taxable by) a particular state – is a question with significant due process implications. The Court, while recognizing "the difficulty of identifying the geographic source of the income earned by a multistate enterprise,"<sup>34</sup> has repeatedly applied the following due process principle to such questions: "[T]he income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'"<sup>35</sup> In a slightly different formulation, the Court has explained that a taxing scheme violates due process rights if there does not exist "a rational relationship between the income attributed to the State and the intrastate values of the enterprise."<sup>36</sup>

---

<sup>32</sup> See e.g., *First Nat'l Bank v. Bellotti*, 435 U.S. 765, 780 (1978) (citing, *Santa Clara County v. Southern Pacific R.R. Co.*, 118 U.S. 394 (1886); *Covington & Lexington Tpk Rd. Co. v. Sandford*, 164 U.S. 578 (1896)).

<sup>33</sup> *Quill*, 504 U.S. at 307 (citation omitted).

<sup>34</sup> *Trinova Corp. v. Mich. Dep't. of Treasury*, 498 U.S. 358, 373 (1991).

<sup>35</sup> *Moorman Mfg. Co.*, 437 U.S. at 273 (1978) (quoting *Norfolk & Western Ry. Co.*, 390 U.S. at 325 (1968); see also, *Mobil Oil Corp. v. Comm'r of Taxes of Vt.*, 445 U.S. 425, 437 (1980).

<sup>36</sup> *Exxon Corp. v. Wis. Dep't. of Revenue*, 447 U.S. 207, 219-20 (1980) (quoting *Mobil Oil Corp.*, 445 U.S. at 437).

## 2. The Statute Constitutes a Facial Denial of Due Process Because It Is Qualitatively Irrational to Determine Any Corporation's In-State Values Based on Another State's Tax Policies

State tax statutes may attribute to a corporate taxpayer's in-state tax-base only those amounts that are rationally related to the taxing state. One of the most fundamental ways that state tax statutes aim to achieve this rational attribution is by allowing deductions for amounts paid to others.<sup>37</sup> Alabama, like most states, starts out on the right path by taking as its starting point for the tax-base calculation the corporation's federal taxable income, a sum which already has such deductions netted out.<sup>38</sup>

Alabama does not stop there, however. With its add-back statute, the State proceeds to impose a critical limitation: An Alabama corporate taxpayer's deduction for certain expenses is allowed (that is, those amounts are removed from the corporation's Alabama tax base) only "to the extent" of the taxability by other states of the corresponding income in the hands of the recipient. To be precise, the statute bases the add-back determination (disallowance of the deduction) on whether the

---

<sup>37</sup> Two corollary approaches, nearly universally applied by the states in conjunction with the deduction approach, are formulary apportionment, and division of the tax base between apportionable ("business") income/expense and allocable ("nonbusiness") income/expense. These tools all must comply with the due process requirement that the state apply its tax only to a corporation's values that are rationally connected to that state.

<sup>38</sup> Ala. Code § 40-18-33.

related-party payment-recipient is "subject to tax" somewhere – and then only if the taxing states have adopted tax regimes that, like Alabama's, require separate legal entities to file separate tax returns rather than taxing an entire unitary group of related corporations on a combined basis.<sup>39</sup> Thus, taxpayers may be entitled to exemption from the add-back to the extent the recipient of the income is taxed in certain states, but not if the recipient is taxed in others. That is, the Alabama add-back statute attributes income to the Alabama tax base of a corporation based upon the tax policy of other states.

Put another way, Alabama's add-back scheme irrationally posits a non-existent linkage between (I) another state's failure to tax an affiliated recipient's income and (II) the measure of the payor's income that is properly attributable to Alabama. By its very design, the add-back statute turns on an entirely extraneous factor – the recipient state's tax policies. This factor neither measures, nor bears any rational relationship to, the extent of the payor's business activities in the taxing jurisdiction – the central concern of due process analysis in this context.

In order to appreciate the true irrationality of the Alabama add-back statute, one might consider a hypothetical "blue eyed officer" add-back statute. Imagine a state statute that denies deductions for interest and royalties paid to related-party corporations – but only to the extent that the officers of the recipient corporation have blue eyes. (No deduction is allowed if all the officers have blue eyes, 75% of the deduction is added back if three-quarters have blue eyes, etc.) This is the kind of

---

<sup>39</sup> Ala. Code § 40-18-35(b)(1).

irrationality that IPT's membership faces, indeed what all affected businesses face, when confronted with the Alabama add-back statute and the other strikingly similar add-back statutes in other states. When related-party expense deduction denials are based on the tax policy of other states, they may as well be denied based on officer eye color, for neither standard is rationally related to corporate values connected with the taxing state.

It may be noted that the appeals court decision in *VFJ Ventures*, adopted in its entirety by the Alabama Supreme Court, limits its due process discussion to what one might call the "quantitative irrationality" analysis in the *Hans Rees*<sup>40</sup> decision of this Court.<sup>41</sup> This quantitative irrationality analysis looks at numbers or percentages – comparing the apportioned tax base produced by the challenged statutory scheme to a hypothetically "correct" tax base, and asks whether the statutory result is "out of all appropriate proportion to the business transacted" by the taxpayer in the taxing state.<sup>42</sup> The "blue-eyed officer add-back" hypothetical demonstrates that the due process "rational relationship" requirement must necessarily have not only a quantitative aspect but a qualitative aspect as well. As demonstrated above, the Alabama add-back statute utterly fails qualitative irrationality analysis.

VFJ's *cert* petition asks the Court to review this case so the Court can tell America's businesses whether Alabama's add-back statute – which makes

---

<sup>40</sup> *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 134 (1931).

<sup>41</sup> *Surtees v. VFJ Ventures, Inc.*, 2008 WL at \*25; App. to Pet. Cert. at 58a.

<sup>42</sup> *Hans Rees' Sons, Inc.*, 283 U.S. at 135.

the tax policy of other states the touch-stone for determining whether a corporation's Alabama tax base should be enlarged – satisfies the “rational relationship” test of *Norfolk*, *Moorman*, *Mobil Oil*, *Exxon*, and other decisions. The Court should grant the writ sought by VFJ in this case in order to bring a prompt halt to the actions of Alabama and many other states, which are trampling without compunction on the due process rights of business taxpayers across America.

## II. THE NEED FOR REVIEW IS URGENT

### A. The Proliferation of Similar Statutes Around the Country, and Continuing Uncertainty Regarding Their Validity, Impose Onerous Compliance Costs on America's Businesses

This Court should grant review because the same facial constitutional defects inhere in numerous similar state laws. If this Court declines to answer the question now, the effect on the nation's economy will be serious. The issue presented in this appeal is more than academic. It has severe practical implications for any corporation doing business in more than one state. There are two reasons for this.

First, add-back statutes are rapidly proliferating. Twenty of the twenty-two add-back statutes were enacted within the last eight years.<sup>43</sup>

---

<sup>43</sup> Twenty-one states and the District of Columbia now have add-back statutes. All were enacted during or after 2001, except for Connecticut's add-back (enacted in 1998) and Ohio's add-back (enacted in 1991). See, Alabama (Ala. Code § 40-18-35(b)); Arkansas (Ark. Code Ann. § 26-51-423(g)); Connecticut (Conn. Gen. Stat. § 12-218c); District of Columbia (D.C. Code

Several other states have recently considered such statutes.<sup>44</sup> The trend is not surprising. States have been attempting to export their tax burdens since as far back as the 1780's, when the Constitution was adopted.<sup>45</sup> But the concern for the national economy

---

Ann. § 47-1803.03(a)(19)); Georgia (Ga. Code Ann. § 48-7-28.3(b)); Illinois (35 Ill. Comp. Stat. 5/203(b)(E-12), (E-13)); Indiana (Ind. Code Ann. §§ 6-3-1-3.5(b)(9), 6-3-2-20); Kentucky (Ky. Rev. Stat. Ann. § 141.205); Maryland (Md. Code Ann., Tax-Gen. § 10-306.1); Massachusetts (Mass. Gen. Laws Ann. ch. 63, §§ 31I, 31J); Michigan (Mich. Comp. Laws § 208.1201(2)(f)); Mississippi (Miss. Code Ann. § 27-7-17(2)); New Jersey (N.J. Stat. Ann. §§ 54:10A-4; 54:10A-4.4); New York (N.Y. Tax Law § 208.9(o)); North Carolina (N.C. Gen. Stat. §105-130.7A); Ohio (Ohio Rev. Code Ann. § 5733.042); Oregon (Or. Admin. R. 150-314.295); Rhode Island (R.I. Gen. Laws § 44-11-11(f)); South Carolina (S.C. Code Ann. § 12-6-1130); Tennessee (Tenn. Code Ann. §§ 67-4-2006(b)(1)(K); 67-4-2006(d)); Virginia (Va. Code Ann. §58.1-402(B)); Wisconsin (Wis. Stat. §§ 71.26(2)(a), 71.80(23)).

<sup>44</sup> Pennsylvania and Minnesota each introduced legislation in 2005. See H.B. 518, 2005 Gen. Assem., Reg. Sess. (Pa. 2005); H.B. 660, S.F. 753, 2005 Leg., 84th Sess. (Minn. 2005). Anecdotal reports indicate that Texas, Iowa, Missouri, and West Virginia have also considered implementing add-back statutes. See e.g., Michael S. Schadewald, *Deducting Related-Party Interest and Intangible Expenses* (2005), <http://www.aicpa.org/pubs/taxadv/online/may2005/schadewald.htm>; Joe Garrett and Kelly W. Smith, *Add-Back Statutes: Where Do We Go From Here?*, Presentation at 2005 SEATA Conference (July 12, 2005), [http://www.seatastates.org/am\\_2005/garrett.pdf](http://www.seatastates.org/am_2005/garrett.pdf); E. Kendrick Smith and Matt Cristy, *Georgia Gets A Grasp On Passive Investment Companies: New Addback Statute Reaches Intangible And Interest Income Flowing From The State* (2005), [http://www.jonesday.com/files/Publication/79016b8a-09fb-4dcc-b235-5a9c21fa29a9/Presentation/PublicationAttachment/4a6d1845-d6ca-4a03-88d25c97dc36a702/Dec2005\\_Smith\\_Cristy.pdf](http://www.jonesday.com/files/Publication/79016b8a-09fb-4dcc-b235-5a9c21fa29a9/Presentation/PublicationAttachment/4a6d1845-d6ca-4a03-88d25c97dc36a702/Dec2005_Smith_Cristy.pdf).

<sup>45</sup> See e.g., Brannon P. Denning, *Confederation-Era Discrimination Against Interstate Commerce and the Legitimacy*

constrains what might be considered good local politics, and it is the responsibility of the courts to "more consistently and coherently bar [unconstitutional] tax exportation."<sup>46</sup>

Second, these statutes are particularly insidious because their effectiveness is directly linked to similar efforts by other states to export their tax burdens. That is, these statutes necessarily piggyback on other states' policy choices. They impact, and are impacted by, the tax laws of any other state in which a company does business. As a result, each change in any state tax law has the potential not only to alter a taxpayer's responsibilities in the state where the change occurred, but also to create a domino effect, upending the tax responsibilities for a single corporation in multiple states across the nation.

The burdens of complying with this Rubik's Cube of state laws are substantial. According to statistics from the Internal Revenue Service, businesses spent over three trillion hours to comply with the federal tax system in 2005. Small businesses accounted for over one trillion of those hours.<sup>47</sup> Compliance with the state tax systems of

---

*of the Dormant Commerce Clause Doctrine*, 94 KY. L.J. 37, 53 (2005/2006) (noting that states' unwillingness to cede control over the levying of imposts and duties during that era was "due to the fact that such measures were a way to raise revenue without directly taxing their citizens.").

<sup>46</sup> See, e.g., Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 897 (1992).

<sup>47</sup> See J. Scott Moody, Wendy Warcholik, & Scott A. Hodge, *The Rising Cost of Complying with the Federal Income Tax*, Tax Foundation Special Report No. 138, 1, 8 (Table 5) (Dec. 2005).

the fifty states is significantly more burdensome, especially where, as here, states attempt to capture revenue based solely on another state's decision not to claim it.<sup>48</sup> To the extent that a company's tax liability is altered, the "piggybacking" of add-back statutes requires a company to review and analyze the procedural requirements for reporting such change in all relevant jurisdictions, recompute the liability, and issue the documentation necessary to meet those varying requirements. Further, the company may have to pay additional tax to several jurisdictions. The piggy-backing effect of the interaction between state add-back statutes and tax changes in other states makes it nearly impossible for companies to anticipate, even approximately, their state tax liability for a given period.

If the add-back statutes are permitted to stand, businesses will continue to be subject to the hefty compliance costs of a shifting, interdependent system of state tax laws, as well as the penalties and interest assessments associated with any inadvertent errors. The only way for corporations to avoid these burdens would be to restructure their entire organizations – and to review their structure again and again each time one state's change in the taxation of royalties or interest caused a domino effect across the nation – in an effort to accommodate these unconstitutional laws. Such restructuring itself comes with substantial costs. Not only must corporations pay for the planning and

---

<sup>48</sup> See Sanjay Gupta and Lillian Mills, *Does Disconformity in State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, NATIONAL TAX JOURNAL 56:2, 355 (June 2003) (indicating that state tax compliance costs are roughly double federal tax compliance costs).

implementation of these corporate changes, but they would also necessarily lose multiple benefits and efficiencies inherent in the corporate structure they have lawfully chosen.<sup>49</sup>

In non-recessionary times, these lost efficiencies and restructuring costs would be onerous. In the midst of faltering sales activity, declining profits, business closures, layoffs and bankruptcies, however, the effect is exacerbated. These burdens would be particularly damaging to small business. A decision from this Court could prevent states from continuing to enforce these unconstitutional laws and further weakening the nation's economy in this way.

### **B. America's Businesses Will Never Be Made Whole, But Prompt Resolution Will Mitigate the Damages**

The issue addressed by this appeal is particularly time-sensitive. Failure to resolve it now will subject businesses to irreparable harm. Until this Court declares the Alabama add-back statute invalid, companies will continue to be compelled to pay unconstitutional taxes that they may never recover. Almost twenty years after this Court required states to provide "meaningful backward looking relief" for taxpayers subjected to unconstitutional taxes, "taxpayers remain unsure

---

<sup>49</sup> As the trial court recognized below, VFJ's organizational structure has significant non-tax benefits, such as improving quality control and oversight of infringement defense, thereby protecting the value of the property, fostering detailed profit analysis, insulating the property from certain liabilities, preventing hostile takeovers, increasing liquidity, and creating economies of scale. See *Surtees v. VFJ Ventures, Inc.*, 2008 WL at \*6; App. to Pet. Cert. at 17a.

about the remedies they can expect" once such statutes have been declared unconstitutional.<sup>50</sup> In fact, "States continue to attempt to avoid paying full refunds to taxpayers...."<sup>51</sup>

Alabama, in particular, has a history of delaying or refusing refunds to taxpayers who remitted tax pursuant to statutes later deemed to be unconstitutional. As recently as September, 2008, the Alabama Supreme Court applied a standard articulated by the lower court for allowing a state to "refus[e] to give a remedy" for tax paid under an unconstitutional statute when "*the state relied on now overturned precedent and the state now faces an extreme hardship if it must give a remedy.*"<sup>52</sup> Although it is unclear what constitutes "extreme hardship," this option could permit a state to refuse refunds to those taxpayers who paid large sums to the Department, or to refuse refunds in the event that numerous taxpayers had remitted the

---

<sup>50</sup> Andres Vallejo and Scott M. Reiber, *Predicting the Remedy for Unconstitutional State Taxes: A Review of Recent Decisions Under the McKesson Framework*, TAX MANAGEMENT MULTISTATE TAX REPORT, Vol. 16, No. 1 at 9 (citing *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18 (1990)).

<sup>51</sup> *Id.* See also, Press Release, California Controller John Chiang, *Chiang Announces Payment Delays to Manage Cash Crisis* (January 16, 2009) (announcing blanket delays for tax refunds to business and individuals due to state cash flow problems).

<sup>52</sup> *Ex parte Surtees (Vulcan Lands, Inc. v. Surtees)*, Nos. 1070386, 1070399, 2008 WL 4369259, at \*3 (Ala. Sept. 26, 2008), (citing *Vulcan Lands, Inc. v. Surtees*, No. 2060607, 2007 WL 4215046, at \*7 (Ala. Civ. App., Nov. 30, 2007)). The Court ultimately held that the Department did not meet the standard, having failed to show that it relied on now overturned precedent.

unconstitutional tax. At the very least, the Alabama decision reflects an intent to deny some refunds of taxes unlawfully collected. The refunds at issue in the *Vulcan Lands* case involve payments of Alabama's foreign franchise tax, which this Court held to be unconstitutional *ten years ago*.<sup>53</sup>

## CONCLUSION

Amicus respectfully submits that there is an urgent need for the Court to grant the writ in this case and move promptly to strike down Alabama's add-back statute which, like the twenty-one similar statutes across the country, denies America's businesses due process of law and undermines the integrity of the national free-trade zone that the Commerce Clause protects. Any delay will make it likely that affected businesses will never be adequately recompensed for their damages, and will also encourage more states to adopt add-back statutes that will continue to impair the free flow of commerce among them. The Court must make it clear to the states that such laws are impermissible. A failure to act will allow not just the continuation of irrational and overreaching taxation, but a continuing escalation of such measures by states anxious to reach values and income beyond their borders.

---

<sup>53</sup> *South Cent. Bell Tel. Co. v. Ala.*, 526 U.S. 160 (1999).

Respectfully submitted,

CASS D. VICKERS  
(*Counsel of Record*)  
Institute for Professionals  
in Taxation  
1200 Abernathy Road NE  
Atlanta, GA 30328  
(850) 907-0692

DONALD M. GRISWOLD  
Reed Smith LLP  
1301 K Street N.W.  
Suite 1100 – East Tower  
Washington DC 20005  
(202) 414-9200

SARA A. LIMA  
Reed Smith LLP  
1650 Market Street  
Philadelphia, PA 19103  
(215) 851-8100

*Attorneys for Amicus Curiae*  
*Institute for Professionals in Taxation*

February 20, 2009

121

③

No. 08-916

The Court, U.S.  
FILED

FEB 23 2009

OFFICE OF THE CLERK

IN THE  
**Supreme Court of the United States**

VFJ VENTURES, F/K/A VF JEANSWEAR, INC.,  
*Petitioner,*

v.

G. THOMAS SURTEES, IN HIS OFFICIAL CAPACITY  
AS COMMISSIONER OF THE DEPARTMENT OF REVENUE  
FOR THE STATE OF ALABAMA, AND  
THE STATE OF ALABAMA DEPARTMENT OF REVENUE,  
*Respondent.*

**On Petition for a Writ of Certiorari  
to the Supreme Court of Alabama**

**BRIEF OF AMICI CURIAE COUNCIL  
ON STATE TAXATION AND NATIONAL  
ASSOCIATION OF MANUFACTURERS  
IN SUPPORT OF PETITIONER**

QUENTIN RIEGEL  
NATIONAL ASSOCIATION OF  
MANUFACTURERS  
1331 Pennsylvania Ave, NW  
Washington, DC 20004  
(202) 637-3000

TODD A. LARD  
*Counsel of Record*  
DOUGLAS L. LINDHOLM  
FREDRICK J. NICELY  
BOBBY L. BURGNER  
J. HUGH MCKINNON  
KEITH LANDRY  
MATTHEW A. MANTLE  
COUNCIL ON STATE  
TAXATION  
122 C St. N.W.  
Suite 330  
Washington, DC 20001  
(202) 484-5222

## TABLE OF CONTENTS

|  | Page |
|--|------|
| TABLE OF AUTHORITIES .....   | ii   |
| INTEREST OF <i>AMICI CURIAE</i> .....  | 1    |
| STATEMENT OF THE CASE .....  | 3    |
| SUMMARY OF THE ARGUMENT .....  | 5    |
| ARGUMENT.....  | 6    |
| I. THIS COURT SHOULD GRANT REVIEW IN ORDER TO PRESERVE FUNDAMENTAL DUE PROCESS AND COMMERCE CLAUSE RESTRICTIONS ON TAXING EXTRATERRITORIAL VALUE.....                | 6    |
| A. Alabama's Add-Back Provision Operating in Conjunction with the Subject-to-tax Exception Violates the Extraterritoriality Principles Embodied in <i>Gore</i> ..... | 7    |
| B. Alabama's Add-Back Provision Violates This Court's Rulings Specific to Other State Taxes Because it is Not Fairly Apportioned .....                               | 12   |
| II. REVIEW BY THIS COURT ON WHETHER THE ALABAMA ADD-BACK STATUTE VIOLATES THE COMMERCE CLAUSE AND DUE PROCESS CLAUSE WILL HAVE RAMIFICATIONS IN MANY STATES.....     | 13   |
| CONCLUSION .....   | 16   |

## TABLE OF AUTHORITIES

| CASES  | Page  |
|--|-------|
| <i>Bigelow v. Virginia</i> , 421 U.S. 809 (1975).....                                | 9     |
| <i>BMW of North America, Inc. v. Gore</i> , 517 U.S. 559 (1996).....                 | 9, 11 |
| <i>Bonaparte v. Tax Court</i> , 104 U.S. 592 (1881).....                             | 9     |
| <i>Container Corp. of Am. v. Franchise Tax Bd.</i> , 463 U.S. 159 (1983).....        | 13    |
| <i>Edgar v. MITE Corp.</i> , 457 U.S. 624 (1982) .                                   | 9     |
| <i>Goldberg v. Sweet</i> , 488 U.S. 252 (1989).....                                  | 12    |
| <i>MeadWestvaco Corp. v. Illinois Dept. of Revenue</i> , 128 S. Ct. 1498 (2008)..... | 7     |
| <i>Moorman Mfg. Co. v. Bair</i> , 437 U.S. 267 (1978).....                           | 12    |
| <i>New York Life Ins. Co. v. Head</i> , 234 U.S. 149 (1914).....                     | 9     |
| <i>Oklahoma Tax Comm'n v. Jefferson Lines, Inc.</i> , 514 U.S. 175 (1995).....       | 13    |
| <i>Trinova Corp. v. Mich. Dep't Treas.</i> , 498 U.S. 358 (1991).....                | 7     |
| STATUTES   |       |
| Ala. Code § 40-18-35 (1975) .....  | 8     |
| Ark. Code Ann. 26-51-423(g)(1) .....   | 14    |
| Conn. Gen. Stat. § 12-218(c) .....   | 14    |
| D.C. Code § 47-1803.03(a)(19)(B).....  | 14    |
| Ga. Code Ann. § 48-7-28.3(d)(2).....   | 14    |
| 35 Ill. Comp. Stat. 5/203(a)(2)(D-18) .....  | 14    |
| Ind. Code § 6-3-2-20(c)(2) .....   | 14    |
| Ky. Rev. Stat. Ann. § 141.205(3)(b) .....  | 14    |
| Md. Code Ann., Tax-Gen. § 10-306.1(c) .....  | 14    |
| Mass. Gen. Laws ch. 63, § 31I.....   | 14    |
| 830 Mass. Code Regs. 63.31.1 .....   | 14    |

## TABLE OF AUTHORITIES—Continued

|   | Page |
|---|------|
| Mich. Comp. Laws § 208.1201(2)(f)(ii).....  | 14   |
| N.J. Stat. Ann. § 54:10A-4.4 .....          | 14   |
| N.J. Admin. Code § 18:7-5.18(b)(3) .....    | 14   |
| N.C. Gen. Stat. 105-130.7A.....             | 14   |
| Ohio Rev. Code Ann. §§ 5733.042, .055(A)(2) | 14   |
| R.I. Gen. Laws § 44-11-11(f)(3) .....       | 14   |
| Tex. Tax Code Ann. § 171.001.....           | 8, 9 |
| Va. Code Ann. § 58.1-402(B)(8)(a)(1) .....  | 14   |

## TREATISES

|   |    |
|---|----|
| Laurence H. Tribe, <i>American Constitutional Law</i> § 7-8 at 1064 (3d ed. 2000).....  | 9  |
| 1 Jerome R. Hellerstein & Walter Hellerstein, <i>State Taxation</i> (3d ed. 2008) ..... | 14 |

## OTHER AUTHORITIES

|  |    |
|--|----|
| John C. Healy & Michael Schadewald, <i>Multistate Corporate Tax Guide</i> (2009) ...   | 14 |
| Multistate Tax Comm'n, <i>Model Statute Requiring the Add-back of Certain Intangible &amp; Interest Expenses</i> (Aug. 17, 2006) ..... | 15 |

IN THE  
**Supreme Court of the United States**

---

No. 08-916

---

VFJ VENTURES, F/K/A VF JEANSWEAR, INC.,  
*Petitioner,*

v.

G. THOMAS SURTEES, IN HIS OFFICIAL CAPACITY  
AS COMMISSIONER OF THE DEPARTMENT OF REVENUE  
FOR THE STATE OF ALABAMA, AND  
THE STATE OF ALABAMA DEPARTMENT OF REVENUE,  
*Respondent.*

---

**On Petition for a Writ of Certiorari  
to the Supreme Court of Alabama**

---

**BRIEF OF AMICI CURIAE COUNCIL  
ON STATE TAXATION AND NATIONAL  
ASSOCIATION OF MANUFACTURERS  
IN SUPPORT OF PETITIONER**

---

**INTEREST OF AMICI CURIAE**

This brief *amici curiae* in support of Petitioner ("VFJ") is filed on behalf of the Council On State Taxation ("COST") and the National Association of Manufacturers ("NAM").<sup>1</sup> COST is a non-profit trade

---

<sup>1</sup> No counsel for a party authored this brief in whole or in part, and no person or entity other than *amici curiae* has made a monetary contribution to the preparation or submission of this

association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST represents more than 600 of the largest multistate businesses in the United States; companies from every industry doing business in every state. The NAM is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media and the general public about the vital role of manufacturing to America's economic future and living standards. *Amici* are in a unique position to offer its view on the constitutional and policy significance of this issue, informed by the business realities of the industries most affected by them.

*Amici's* members are concerned that Alabama's add-back statute, which imposes a discriminatory and extraterritorial restriction on a taxpayer's ability to deduct ordinary business expenses, has created a dangerous precedent and will subject taxpayers to inconsistent and unconstitutional taxation. *Amici's* members are concerned that, if left standing, the Supreme Court of Alabama's acceptance of such an unconstitutional add-back statute will lead courts in other states that have enacted similar legislation to similarly uphold this unsound theory of taxation, thereby exacerbating the risk of multiple taxation of the same income or value.

---

brief. The parties received timely notice of *amici's* intent to file this brief. Written consent of all parties to the filing of this brief has been filed with the Clerk of this Court.

## STATEMENT OF THE CASE

This case raises the constitutional issue of whether a state can selectively and discriminately deny taxpayers the ability to deduct legitimate expenses, the resolution of which will greatly affect virtually every large company doing business in any state that attempts to enforce an add-back statute similar to that imposed by the State of Alabama. In 2001, the Alabama legislature amended Ala. Code § 40-18-35 (1975) by including one of the nation's first "add-back" provisions. This provision essentially restricts the ability of a taxpayer to deduct as expenses certain intangible and interest payments made to related companies. The statute does this by requiring those types of payments, when made to related companies, to be added back to the taxpayer's taxable income: added back because they were already deducted for purposes of the starting point of the tax, federal taxable income. By offering several exceptions, however, the statute allows taxpayers to deduct certain payments. While the Petitioner certainly raises legitimate concerns about the constitutionality of the overall operation of add-back statute, *Amici* will focus primarily on the application of the so-called "subject-to-tax" exception to the general add-back provision. Simply stated, the subject-to-tax exception allows taxpayers to deduct payments to some related entities, but only if those related entities are subject to a sufficient level of income tax in Alabama or another state.

The expenses targeted by the Alabama Department of Revenue ("ADOR") in this case were VFJ's royalty payments to H.D. Lee Company, Inc. ("Lee") and Wrangler Clothing Corp. ("Wrangler"). Lee and Wrangler actively manage VFJ's valuable trademarks

through employees and operations located in Delaware. VFJ manufactures and sells jeans and other clothing in Alabama and throughout the world. Relying on the add-back statute, the ADOR disallowed (or added back) VFJ's royalty payments to Lee and Wrangler. This resulted in a tax assessment of more than \$1 million and a subsequent challenge of the statute's validity by VFJ.

In January 2007, the Circuit Court of Montgomery County, Alabama, held a four-day trial and concluded that the unreasonable exception to the add-back statute applied to VFJ's royalty payments because the payments had economic substance and a legitimate business purpose. The Circuit Court also briefly addressed whether the "subject-to-tax" exception applied. The Circuit Court held that the "subject-to-tax" exception should be measured on a pre-apportionment basis (before income is apportioned to Alabama). Accordingly, the court found that Lee's and Wrangler's income was subject to tax in another state—North Carolina. Because the court held in favor of VFJ on these points, the Circuit Court declined to address the challenges by VFJ that the entire add-back statute violated the United States Constitution.

In February 2008, the Alabama Court of Civil Appeals reversed the Circuit Court's finding that the add-back would be unreasonable. The Court of Civil Appeals adopted the ADOR's interpretation of what would qualify as "unreasonable," namely that the add back of income had to be out of proportion to the taxpayer's presence in Alabama. Regarding the "subject-to-tax" exception, the Court of Civil Appeals again gave great deference to the ADOR position that "subject-to-tax" should apply on a post-apportionment basis (income apportioned to Alabama) and not on a pre-apportionment basis as determined by the Circuit

Court. Lastly, addressing the constitutionality of the add-back provision, the Court of Civil Appeals held that Alabama's add-back provision passed constitutional scrutiny. The Court of Civil Appeals, counter to VFJ's arguments, found that the tax was fairly apportioned, was externally consistent, and was not facially discriminatory.

In September 2008, the Supreme Court of Alabama summarily affirmed the judgment of the Alabama Court of Civil Appeals, adopting the court's analysis and opinion in its entirety as its own, stating that it "see[s] no need to explicate further." *Ex Parte VFJ Ventures, Inc. (Surtees v. VFJ Ventures, Inc.)*, No. 1070718 (Ala. Sept. 19, 2008). The Supreme Court of Alabama offered no independent analysis whatsoever regarding any of the constitutional issues presented, including those presented by *amici*.

### SUMMARY OF THE ARGUMENT

This Court should grant review in order to preserve fundamental Due Process and Commerce Clause requirements it has long recognized. In its application, the Alabama add-back statute creates situations where a taxpayer's Alabama tax liability can vary not based on its activities in-state or changes in Alabama law, but based entirely on its activities and tax policy shifts outside of Alabama. Such overreaching by the State of Alabama is not fair apportionment and should not survive constitutional scrutiny. The Alabama add-back statute violates this Court's extraterritorial principle by inextricably linking the ability to deduct certain expenses with the amount of income tax a related company might have paid to another state. Increasing Alabama tax liability simply because another state or jurisdiction cannot or chooses not to tax income from the use of intangibles or tax

corporate groups on a combined basis is an unconstitutional enactment of extraterritorial law.

The issue of extraterritorial taxation from such add-back statutes unfortunately arises not only in Alabama, but also in the nearly 20 other jurisdictions across the country that have enacted similar legislation. Immediate review of the constitutionality of Alabama's add-back statute is essential for both taxpayers unduly burdened by these types of provisions, and states unnecessarily burdened by administrative costs and potential refund liabilities resulting from continued imposition of these types of unconstitutional taxing schemes. This Court's guidance and ultimate resolution regarding the limits of extraterritorial taxation will remove the fog of uncertainty over this issue and bring clarity to both taxpayers and the states.

## ARGUMENT

### **I. THIS COURT SHOULD GRANT REVIEW IN ORDER TO PRESERVE FUNDAMEN- TAL DUE PROCESS AND COMMERCE CLAUSE RESTRICTIONS ON TAXING EXTRATERRITORIAL VALUE**

The Petitioner has made sound and logical arguments as to why the Alabama add-back statute violates the nondiscrimination and fair-apportionment requirements of the Commerce Clause, thus compelling a grant of *certiorari* in this case. We agree with the petitioner's conclusions and will not restate all of those arguments here. Rather, this brief will focus on the extraterritorial encroachment of the Alabama add-back statute and the related violations of the fair apportionment requirements of the Commerce Clause and Due Process Clause.

Alabama's add-back provision, as interpreted by the Supreme Court of Alabama, unconstitutionally increases the tax burden of select businesses engaged in interstate commerce. It does so by punitively increasing the Alabama tax burden on taxpayers by requiring those taxpayers to add back certain payments made to select related members that are neither subject to income taxation in Alabama nor subject to sufficient level of tax in another state. This specific targeting of companies based upon the level of taxes imposed by other states violates the United States Constitution.

**A. Alabama's Add-Back Provision Operating in Conjunction with the Subject-to-tax Exception Violates the Extraterritoriality Principles Embodied in *Gore***

During the last term, this Court took the opportunity to reiterate its long-standing principle that "[t]he Due Process and Commerce Clauses forbid the States to tax 'extraterritorial values.'" *MeadWestvaco Corp. v. Illinois Dept. of Revenue*, 128 S.Ct. 1498, 1502 (2008). Indeed, this court has acknowledged that the taxation of interstate commerce "provide[s] the opportunity for a State to export tax burdens and import tax revenues." *Trinova Corp. v. Mich. Dep't Treas.*, 498 U.S. 358, 374 (1991). The Alabama add-back statute operating in conjunction with the "subject-to-tax exception" violates this extraterritorial prohibition by inextricably linking the ability to deduct certain expenses with the amount of income tax a related company might have paid to another state. This linking of Alabama income tax liability to the amount of income tax paid in other states is an unconstitutional enactment of an extraterritorial law.

The Alabama add-back statute consists of a general rule and several complex exceptions. The general add-back rule does not allow a taxpayer to deduct most payments for intangibles or interest to related members even though the payment is deductible for federal income tax purposes. Ala. Code § 40-18-35 (1975). However, several statutory exceptions allow some related company payments to be deducted. The exception of relevance here is the "subject-to-tax" exception. *Id.*

The subject-to-tax exception essentially allows a deduction if the related company receiving the payment is subject to a sufficient level of income tax in another jurisdiction, or subject to Alabama's income tax. According to the Supreme Court of Alabama, it is not enough that the income of the related company is included in a return in another state. Rather the Supreme Court of Alabama, in wholly adopting the Court of Civil Appeals' opinion, requires "the income at issue [must be] actually taxed as a part of a tax on net income." *Surtees v. VFJ Ventures, Inc.*, No. 2060478, slip op. at 58 (Ala. Civ. App. Feb. 8, 2008). By asserting that Alabama will only allow deductions for a payment to the extent another state chooses to tax the recipient of the payment, Alabama has essentially anointed itself as tax collector for the rest of the states. It is simply not within Alabama's jurisdiction, no matter what direct or indirect means the state chooses, to assess tax outside its borders.

A simple and all-too-familiar fact scenario illustrates the extraterritorial nature of the Alabama add-back statute. For many years, the State of Texas imposed a franchise tax on the earned surplus or taxable capital of companies doing business in Texas. Tex. Tax Code Ann. § 171.001. Although the tax was labeled a franchise tax, it was generally considered a

tax on income. Effective January 1, 2007, Texas significantly altered its franchise tax, effectively replacing it with a "taxable margin tax," which is imposed on gross receipts rather than income. Tex. Tax Code Ann. § 171.001. A typical taxpayer with consistent and unchanged operations in Texas and Alabama might expect to see its Texas tax liability change because of the Texas law change. However, it is very likely that the same taxpayer could also see its Alabama tax increase solely because of the Texas law change.

Under the former Texas franchise tax, payments to a related company located in Texas would likely qualify for Alabama's subject-to-tax exception. However, payments to the same entity subject to the new taxable margin tax may not qualify for the subject-to-tax exception because the new margin tax is arguably not a tax on income. In its application, the Alabama add-back statute creates situations where a taxpayer's Alabama tax liability can vary not based on its activities in-state or changes in Alabama law, but based entirely on its activities and tax policy shifts outside of Alabama.

In a series of cases not involving taxes, this Court has crafted careful limits on the ability of a state to control activities beyond its borders. These cases support a conclusion that neither the activities of businesses in other states nor the taxing policies of other states are the proper subject of an Alabama statute. While "Congress has ample authority to enact such . . . polic[ies] for the entire Nation, it is clear that no single State could do so, or even impose its own policy choice on neighboring states." See *Bonaparte v. Tax Court*, 104 U.S. 592, 594 (1881) ("No State can legislate except with reference to its own jurisdiction. . . ."). See also *BMW of North America*,

*Inc. v. Gore*, 517 U.S. 559, 571 (1996) (stating that while Congress has the authority to enact policies for the entire nation, "it is clear that no single State could do so, or even impose its own policy choice on neighboring States"); *Bigelow v. Virginia*, 421 U.S. 809 (1975) (finding that while Virginia had a legitimate interest in maintaining the quality of medical care services provided within its borders, it had no authority to regulate such services provided in New York); *New York Life Ins. Co. v. Head*, 234 U.S. 149, 161 (1914) (finding that to permit the statutes of one state to operate beyond the jurisdiction of that state would remove "the constitutional barriers by which all the States are restricted within the orbits of their lawful authority and upon the preservation of which the Government under the Constitution depends. This is so obviously the necessary result of the Constitution that it has rarely been called in question and hence authorities directly dealing with it do not abound"). The "Commerce Clause . . . precludes the application of a state statute to commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the State." *Edgar v. MITE Corp.*, 457 U.S. 624, 642-43 (1982).

As *Gore* and its precedents make clear, the fact that other states choose not to impose income tax on income from the use of intangibles or to tax corporate groups on a combined basis is not an act Alabama can correct. As the leading Constitutional treatise notes, "the Court has articulated virtually a *per se* rule of invalidity for extraterritorial state regulations—i.e., laws which directly regulate out-of-state commerce, or laws whose operation is triggered by out-of-state events." Laurence H. Tribe, *American Constitutional Law* § 7-8 at 1064 (3d ed. 2000). It is undisputed that the add-back statute and its subject-to-tax exception

are only triggered by events occurring outside of Alabama, events which have absolutely no relationship to a taxpayer's business activities in Alabama, and have no relationship to the measurement of earnings reasonably attributable to Alabama.

In *Gore*, this Court rejected Alabama's imposition of economic sanctions to induce BMW to change a nationwide policy. The Supreme Court held that the amount of a state punitive damages award could not be based on BMW's failure to disclose presale repairs in other states. Although not a tax case, the similarity to Alabama's add-back statute with the subject-to-tax exception is striking. That is, just as Alabama sought to impose economic sanctions to discourage BMW from nondisclosure of presale repairs in other states, the ADOR contends that Alabama may penalize taxpayers who do not pay similar income taxes in other states.

In finding Alabama's punitive damages award unconstitutional in *Gore*, the Court held that a "State's power to impose burdens on the interstate market . . . is not only subordinate to the federal power over interstate commerce, but is also constrained by the need to respect the interests of other States." *Gore*, 517 U.S. at 571 (citation omitted). While modern commerce may be conducted in such a way that blurs strict geographical boundaries, the boundaries on Alabama's ability to impose tax remain crystal clear. Alabama simply is not permitted to enact a law that is triggered by out-of-state events.

**B. Alabama's Add-Back Provision Violates  
This Court's Rulings Specific to Other  
State Taxes Because it is Not Fairly  
Apportioned**

In addition to contradicting this Court's logic in *Gore*, the Alabama add-back provision also runs counter to this Court's established standards for examining the constitutionality of apportioned state taxes. The deliberate extraterritorial reach of the add-back statute and the subject-to-tax exception violates the Due Process Clause of the Fourteenth Amendment of the United States Constitution because the Due Process Clause requires that when a state taxes an interstate business, "the income attributed to the State for tax purposes must be rationally related to values connected with the taxing state." *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978) (internal quotation omitted). An income measurement based on whether a taxpayer is subject to tax in another state can never be rationally related to values connected with Alabama.

The deliberate extraterritorial reach of the add-back statute and the subject-to-tax exception also necessarily results in a violation of the fair apportionment requirement of the Commerce Clause because it intentionally increases a taxpayer's Alabama tax liability based upon an amount of tax paid in other states. Although the states are given significant discretion in determining how to apportion income, the "central purpose behind the apportionment requirement is to ensure that each State taxes only its fair share of an interstate transaction." *Goldberg v. Sweet*, 488 U.S. 252, 260-61 (1989). The add-back statute with the subject-to-tax exception violates the Commerce Clause by purposefully exceeding its "fair share" of the income relating to the interstate activi-

ties of corporations and by ignoring objective measures (*i.e.*, legitimate expenses) of a corporation's activities outside of Alabama.

The add-back statute operating in conjunction with the subject-to-tax exception also violates the external consistency requirement of fair apportionment. See *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165 (1983). The requirement of "external consistency" in an apportionment formula specifically looks to "whether a State's tax reaches beyond the portion of value that is fairly attributable to economic activity within the taxing State." *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995). Accordingly, Alabama's taxing scheme violates the external consistency requirement by deliberately reaching beyond the portion of income that is fairly attributable to economic activity within Alabama.

## **II. REVIEW BY THIS COURT ON WHETHER THE ALABAMA ADD-BACK STATUTE VIOLATES THE COMMERCE CLAUSE AND DUE PROCESS CLAUSE WILL HAVE RAMIFICATIONS IN MANY STATES**

The central issue in this brief *amici curiae* with respect to the application of the Commerce Clause to the Alabama add-back statute is whether the State impermissibly taxed extraterritorial values. Due to the recent, albeit misguided, popularity of the add-back concept to revenue agencies, many other states have also implemented add-back statutes that rely on activities or competing tax policies well beyond the borders of the taxing state in order to justify an increased in-state tax liability. These taxes resulting from add-back statutes are indeed extraterritorial in

nature, and a ruling on the Alabama add-back provision by this Court could very well affect the application of these taxes in other states.

Currently, twenty other states and the District of Columbia have adopted similar add-back statutes, while other states continue to contemplate such action. *See* 1 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 7.17[3] n.550 (3d ed. 2008) (noting the following jurisdictions have enacted add-back provisions to their income tax statutes: Alabama, Arkansas, Connecticut, District of Columbia, Georgia, Illinois, Indiana, Kentucky, Maryland, Massachusetts, Mississippi, New Jersey, New York, North Carolina, Ohio, Rhode Island, South Carolina, Tennessee, Virginia, and Wisconsin); *see also* John C. Healy & Micheal Schadewald, *Multistate Corporate Tax Guide* I-405 (2009) (noting, in addition to the states listed above, Michigan and Oregon also have enacted add-back provisions to their income tax statutes); Almost all of these add-back statutes contain a subject-to-tax exception similar to that used in Alabama.<sup>2</sup> The Alabama add-back statute is typical of the types being implemented across the states and is, in fact, commonly used in scholarly works as the quintessential example describing this category of statutory provisions. *See* Hellerstein, at ¶ 7.17[3][a]

---

<sup>2</sup> *See* Ark. Code Ann. 26-51-423(g)(1); Conn. Gen. Stat. § 12-218(c); D.C. Code § 47-1803.03(a)(19)(B); Ga. Code Ann. § 48-7-28.3(d)(2); 35 Ill. Comp. Stat. 5/203(a)(2)(D-18); Ind. Code § 6-3-2-20(c)(2); Ky. Rev. Stat. Ann. § 141.205(3)(b); Md. Code Ann., Tax-Gen. § 10-306.1(c); Mass. Gen. Laws ch. 63, § 31I; 830 Mass. Code Regs. 63.31.1; Mich. Comp. Laws § 208.1201(2)(f)(ii); N.J. Stat. Ann. § 54:10A-4.4; N.J. Admin. Code § 18:7-5.18(b)(3); N.C. Gen. Stat. 105-130.7A; Ohio Rev. Code Ann. §§ 5733.042, .055(A)(2); R.I. Gen. Laws § 44-11-11(f)(3); Va. Code Ann. § 58.1-402(B)(8)(a)(1).

("Most of the state's expense disallowance provisions require a taxpayer to add back to income otherwise deductible expenses that fall within an identifiable set of related-company transactions. The Alabama statute is typical. It requires a taxpayer to . . ." (emphasis added)). In addition, the Multistate Tax Commission (MTC)—an organization of state tax administrators who strive to enact uniform laws—has even adopted a model statute requiring taxpayers to add back certain intangible and interest expenses in computing state taxable income. See Multistate Tax Comm'n, *Model Statute Requiring the Add-Back of Certain Intangible & Interest Expenses* (2008).

The heavy burdens ultimately felt by the continued use of these types of unconstitutional taxation schemes are not limited to the taxpayers alone. It is apparent that taxpayers are currently unduly burdened by such add-back provisions, with VFJ's own tax liability having increased by over \$1 million in a single tax year. In addition, however, this current lack of constitutional clarity has resulted in considerable administrative costs borne by states currently involved in contentious litigation regarding the matter. Many of the states (including those planning to adopt such provisions) may also be exposed to ever-growing refund liabilities and resulting budget shortfalls that coincide with mandatory retroactive relief they will be forced to provide should the unconstitutionality of these types of add-back provisions be confirmed. Swift clarification by this Court would alleviate such unnecessary burdens for both taxpayers and the states.

## CONCLUSION

In its application, the Alabama add-back provision creates situations where a taxpayer's Alabama tax liability can vary not based upon its Alabama activities, but based entirely upon its activities outside of Alabama. Such overreaching by the State of Alabama should not survive constitutional scrutiny. The Alabama add-back statute operating in conjunction with the "subject-to-tax exception" violates this extraterritorial prohibition by inextricably linking the ability to deduct certain expenses with the amount of tax a related company might have paid to another state. This linking of Alabama tax liability to the amount of tax paid in other states is an unconstitutional enactment of an extraterritorial law.

The issue of extraterritorial taxation arises not only in Alabama, but also in other states across the country (and even in other areas of state and local taxes). Immediate review of the constitutionality of Alabama's add-back statute is essential for both taxpayers unduly burdened by these types of provisions, and states unnecessarily burdened by high administrative costs, potential refund liabilities, and associated budgetary deficits resulting from continued imposition of these types of unconstitutional taxing schemes. This Court's guidance and ultimate resolution regarding the limits of extraterritorial taxation will remove the fog of uncertainty over this issue and bring clarity not only to taxpayers, but also to states that have enacted (or are planning to enact) these types of impermissible add-back statutes.

Respectfully submitted,

QUENTIN RIEGEL  
NATIONAL ASSOCIATION OF  
MANUFACTURERS  
1331 Pennsylvania Ave, NW  
Washington, DC 20004  
(202) 637-3000

TODD A. LARD  
*Counsel of Record*  
DOUGLAS L. LINDHOLM  
FREDRICK J. NICELY  
BOBBY L. BURGNER  
J. HUGH MCKINNON  
KEITH LANDRY  
MATTHEW A. MANTLE  
COUNCIL ON STATE  
TAXATION  
122 C St. N.W.  
Suite 330  
Washington, DC 20001  
(202) 484-5222

121

3

No. 08-916

Supreme Court, U.S.  
FILED

FEB 23 2009

OFFICE OF THE CLERK

---

IN THE  
**Supreme Court of the United States**

---

VFJ VENTURES, INC.,  
*Petitioner,*

v.

G. THOMAS SURTEES, IN HIS OFFICIAL  
CAPACITY AS COMMISSIONER OF THE  
ALABAMA DEPARTMENT OF REVENUE, *ET AL.*,  
*Respondent.*

---

**On Petition for a Writ of Certiorari to the  
Alabama Supreme Court**

---

**BRIEF OF TAX EXECUTIVES INSTITUTE, INC.  
AS AMICUS CURIAE  
IN SUPPORT OF THE PETITIONER**

---

ELI J. DICKER \*  
DANIEL B. DE JONG  
TIMOTHY J. MCCORMALLY  
TAX EXECUTIVES INSTITUTE, INC.  
1200 G Street, N.W., Suite 300  
Washington, D.C. 20005  
(202) 638-5601

\* Counsel of Record

*Counsel for Amicus Curiae  
Tax Executives Institute, Inc.*

February 23, 2009

## TABLE OF CONTENTS

|   | Page |
|---|------|
| TABLE OF AUTHORITIES .....  | ii   |
| INTEREST OF <i>AMICUS CURIAE</i> .....  | 1    |
| SUMMARY OF ARGUMENT .....   | 3    |
| ARGUMENT .....  | 6    |
| I. BACKGROUND .....   | 6    |
| II. STATUTORY OVERVIEW .....  | 8    |
| A. Determining State Taxable Income ....  | 8    |
| B. Alabama's "Add-Back" Statute .....   | 10   |
| III. THE ALABAMA ADD-BACK STATUTE<br>VIOLATES THE COMMERCE CLAUSE<br>BY IMPERMISSIBLY TAXING IN-<br>COME BEYOND ALABAMA'S CON-<br>STITUTIONAL REACH ..... | 11   |
| CONCLUSION .....  | 20   |

## TABLE OF AUTHORITIES

| CASES  | Page          |
|--|---------------|
| <i>Baldwin v. G.A.F. Seelig, Inc.</i> , 294 U.S. 511 (1935).....   | 3, 12         |
| <i>Boston Stock Exchange v. State Tax Commission</i> , 429 U.S. 318 (1977).....  | 3, 12, 14     |
| <i>Butler Brothers v. McColgan</i> , 315 U.S. 501 (1942).....  | 5, 16         |
| <i>Complete Auto Transit, Inc. v. Brady</i> , 430 U.S. 274 (1977).....   | 2, 4, 12      |
| <i>Connecticut General Life Ins. Co. v. Johnson</i> , 303 U.S. 77 (1938).....  | 4, 12, 13     |
| <i>Container Corp. v. Franchise Tax Board</i> , 463 U.S. 159 (1983).....   | 5, 13, 14, 16 |
| <i>Exxon Corp. v. Department of Revenue</i> , 447 U.S. 207 (1980).....   | 13            |
| <i>Hunt-Wesson, Inc. v. Franchise Tax Board</i> , 528 U.S. 458 (2000).....   | 2, 5, 18, 19  |
| <i>Hunt-Wesson, Inc. v. Franchise Tax Board</i> , No. 976628, Cal. Superior Ct., City and County of San Francisco, Dep't. 17, June 6, 1997, <i>rev'd</i> , No. A079969, Cal. Ct. App. 1st Dist., Div. 3, Dec 11, 1998 (unpublished)..... | 6, 19         |
| <i>Mobil Oil Corp. v. Commissioner of Taxes</i> , 445 U.S. 425 (1980).....   | 4, 15, 16     |
| <i>New Energy Co. v. Limbach</i> , 486 U.S. 269 (1988).....  | 5, 18         |
| <i>Oregon Waste Systems, Inc. v. Department of Environmental Quality of Oregon</i> , 511 U.S. 93 (1994).....   | 5, 18         |
| <i>South Central Bell Tel. Co. v. Alabama</i> , 26 U.S. 160 (1999).....  | 18            |
| <i>Tambrands, Inc. v. State Tax Assessor</i> , 595 A.2d 1039 (Me. 1991).....   | 17            |

## TABLE OF AUTHORITIES—Continued

|   | Page  |
|---|-------|
| <i>Trinova Corp. v. Michigan Department of Treasury</i> , 498 U.S. 358 (1991) ..... | 13    |
| <i>Underwood Typewriter Co. v. Chamberlain</i> , 254 U.S. 113 (1920) .....          | 5, 15 |
| <i>Wisconsin v. J.C. Penney Co.</i> , 311 U.S. 435 (1940) .....                     | 14    |

## CONSTITUTIONAL PROVISIONS

|                                      |    |
|--------------------------------------|----|
| U.S. Const. art. I, § 8, cl. 3 ..... | 11 |
| U.S. Const. amend. XIV, § 1 .....    | 11 |

## STATUTES AND REGULATIONS

|   |       |
|---|-------|
| Ala. Code 1975 § 40-18-31 .....             | 9     |
| Ala. Code 1975 § 40-18-33 .....             | 9     |
| Ala. Code 1975 § 40-18-35(b) .....          | 7, 10 |
| Ala. Code 1975 § 40-18-39(a) .....          | 8     |
| Ala. Code 1975 § 40-18-39(c) .....          | 8     |
| Ala. Code 1975 § 40-18-39(c)(1) .....       | 9, 15 |
| Ala. Code 1975 § 40-18-39(i) .....          | 8     |
| Ark. Code Ann. § 26-51-423(g)(1) .....      | 10    |
| Cal. Rev. & Tax Code § 25101 .....          | 11    |
| Conn. Gen. Stat. § 12-218(c) .....          | 11    |
| D.C. Code § 47-1803.03(a)(19)(B) .....      | 11    |
| Ga. Code Ann. § 48-7-28.3(d)(2) .....       | 10    |
| 35 Ill. Comp. Stat. 5/203(a)(2)(D-18) ..... | 10    |
| Ind. Code § 6-3-2-20(c)(2) .....            | 10    |
| Ky. Rev. Stat. Ann. § 141.205(3)(b) .....   | 10    |
| Me. Rev. Stat. Ann. § 5220(5) .....         | 11    |
| Md. Code Ann. Tax-Gen. § 10-306.1(c) .....  | 11    |
| Md. Code Ann. Tax-Gen. § 10-811 .....       | 11    |
| Mass. Gen. Laws ch. 63, § 31I .....         | 11    |
| 830 Mass. Code Regs. 63.31.1 .....          | 11    |
| Mich. Comp. Laws § 208.1201(2)(f)(ii) ..... | 10    |

## TABLE OF AUTHORITIES—Continued

|  | Page |
|--|------|
| N.J. Stat. Ann. § 54:10A-4.4 .....   | 11   |
| N.J. Admin. Code § 18:7-5.18(b)(3).....  | 11   |
| N.C. Gen. Stat. § 105-130.7A.....  | 11   |
| Ohio Rev. Code Ann. § 5733.042.....  | 11   |
| Ohio Rev. Code Ann. § 5733.055(A)(2) .....   | 11   |
| 72 P.S. § 7404 .....   | 11   |
| R.I. Gen. Laws § 44-11-11(f)(3).....   | 11   |
| Va. Code Ann. § 58.1-402(B)(8)(a)(1) .....   | 11   |
| <br>UNIFORM LAWS   |      |
| Uniform Division of Income for Tax<br>Purposes Act .....   | 14   |
| <br>OTHER AUTHORITIES  |      |
| JEROME R. HELLERSTEIN & WALTER<br>HELLERSTEIN, STATE TAXATION I: COR-<br>PORATE INCOME AND FRANCHISE TAXES<br>(3d ed. 2008)..... | 13   |

IN THE  
**Supreme Court of the United States**

---

No. 08-916

---

VFJ VENTURES, INC.,  
*Petitioner,*

v.

G. THOMAS SURTEES, IN HIS OFFICIAL  
CAPACITY AS COMMISSIONER OF THE  
ALABAMA DEPARTMENT OF REVENUE, *ET AL.*,  
*Respondent.*

---

**On Petition for a Writ of Certiorari to the  
Alabama Supreme Court**

---

**BRIEF OF TAX EXECUTIVES INSTITUTE, INC.  
AS *AMICUS CURIAE*  
IN SUPPORT OF THE PETITIONER**

---

**INTEREST OF *AMICUS CURIAE***

Pursuant to Rule 37 of the Rules of this Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of the petition for a writ of certiorari.<sup>1</sup> Tax Executives Institute

---

<sup>1</sup> Pursuant to Rule 37.6, *amicus* Tax Executives Institute, Inc. states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Pursuant to Rule 37.2(a), counsel of record for both parties received timely notice

(hereinafter "TEI" or "the Institute") is a voluntary, non-profit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. TEI was organized in 1944 under the laws of the State of New York and is exempt from taxation under section 501(c)(6) of the Internal Revenue Code (26 U.S.C.). The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws, reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and vindicating the Commerce Clause and other constitutional rights of all business taxpayers.

The issue presented is whether the State of Alabama's "add-back" statute, which denies a deduction for ordinary business expenses paid to corporations located outside Alabama, discriminates against interstate commerce in violation of the Commerce Clause. Alabama is not alone among the States in enacting legislation that reaches beyond its borders to tax extraterritorial values in contravention of the Commerce Clause. Indeed, Alabama's "add-back" statute is just the latest effort to distend the Court's decisions in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000), and other cases by unconstitutionally using a State's taxing authority to exact from multijurisdictional taxpayers that which is not its due.

TEI has more than 7,000 members who represent more than 3,200 of the leading corporations in the United States, Canada, Europe and Asia, including many domiciled or doing business in Alabama. TEI

---

of the intent to file an *amicus* brief under this rule and both parties have consented to its submission in letters filed with the Clerk.

members represent a cross-section of the business community whose employers are, almost without exception, engaged in interstate commerce. TEI has a keen interest in the resolution of issues relating to the constitutionality of Alabama's "add-back" statute, not only with respect to its members whose companies are taxed by Alabama but also in respect of those in the approximately 20 other States with "add-back" statutes. The disposition of this case will have a direct bearing on the permissibility of the "add-back" device across the Nation and, indirectly, States' other efforts to tax beyond their borders.

### SUMMARY OF ARGUMENT

1. The core issue presented by this case is whether the State of Alabama's "add-back" statute violates the Commerce Clause of the Constitution. It is well settled that a State may not tax value outside its borders. Such taxation is forbidden because the "fundamental purpose of the [Commerce] Clause is to assure that there be free trade among the several States," *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 335 (1977), and because extraterritorial taxation offends fundamental notions of due process and constitutes an "unreasonable clog upon the mobility of commerce." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935).

2. Like many States, Alabama imposes a corporate income tax on corporations doing business within its borders. Alabama has chosen to impose its corporate income tax on a "separate company" basis. A direct consequence of that policy choice is the requirement that Alabama must recognize the separate existence of individual corporations. It is within this separate company reporting context that Alabama's "add-back" statute must be tested by and withstand the

scrutiny of the Commerce Clause and the Due Process Clause. Alabama's "add-back" statute fails that test.

3. Alabama's "add-back" statute, like those of many other States, requires corporate taxpayers to "add-back" otherwise deductible interest and intangible expenses paid to or incurred with respect to related members. This "add-back" does not apply, however, to interest and intangible expenses to the extent the related corporation is subject to tax in a State that mandates separate company filing for corporate taxpayers and that taxes intangible income such as royalties. As a result, the amount of interest and intangible expenses taxable in Alabama fluctuates based on the taxing scheme in the States in which the recipient does business — not on the taxpayer's level of activity in Alabama.

4. In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), this Court established a four-prong test for determining whether a state tax statute violates the Commerce Clause — that is to say, whether it impermissibly reaches extraterritorial values. These four tests are not wholly independent of one another, but rather represent four ways of answering the same question — whether a State is attempting to tax "value outside its borders." See *Connecticut General Life Ins. Co. v. Johnson*, 303 U.S. 77, 80-81 (1938). Alabama's "add-back" statute does not satisfy the requirements of *Complete Auto Transit*.

5. Alabama's "add-back" statute does not pass the fair apportionment test. Fair apportionment necessitates a "rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 436-37 (1980). The failure to provide factor representation is "inherently arbi-

trary," *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920), and cannot help but produce a result that reflects neither "a reasonable sense of how [the] income [was] generated" (as required by *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 169 (1983)) nor "the relative contribution of the activities in the various States [specifically, Alabama] to the production of total unitary income" (*Butler Brothers v. McColgan*, 315 U.S. 501, 509 (1942)). Because the amount of royalty income taxable in Alabama under its "add-back" statute is controlled by the taxing choice of other States, there is no rational relationship between the royalties Alabama seeks to tax and a taxpayer's activities in Alabama. Alabama may not constitutionally cherry pick items of income or expense (to include or exclude) in order to increase the taxes it exacts from multijurisdictional companies without making correlative adjustments to the formula used to apportion the income among Alabama and the other States.

6. To survive constitutional challenge a State tax must not discriminate against interstate commerce. The prohibition on discrimination was borne of a fear of "economic protectionism — that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors." *New Energy Co. v. Limbach*, 486 U.S. 269, 273-74 (1988). This Court has defined "discrimination" for purposes of Commerce Clause analysis as "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." *Oregon Waste Systems, Inc. v. Department of Environmental Quality of Oregon*, 511 U.S. 93, 99 (1994). Most recently, in *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000), this Court

struck down a California statute requiring the reduction of a taxpayer's interest deduction by the amount of its nontaxable income without regard to whether the interest expense was related to the nontaxable income. Holding the interest offset provision unconstitutional, the California trial court noted that the statute resulted in treating corporations differently solely based on the corporation's "state of commercial domicile, which difference results in increased taxes for foreign corporations." *Hunt-Wesson, Inc. v. Franchise Tax Board*, No. 976628, Cal. Superior Ct., City and County of San Francisco, Dep't 17, June 6, 1997, *rev'd*, No. A079969, Cal. Ct. App., 1st Dist., Div. 3, Dec. 11, 1998 (unpublished). This Court unanimously agreed and struck down the statute. Here, Alabama's statute is equally infirmed. Under Alabama's "add-back" statute, royalties do not need to be "added-back" if they are paid to related parties doing business in either Alabama or other States whose taxation of royalty income mirrors that of Alabama. Thus, the "add-back" statute unconstitutionally discriminates in favor of royalties paid to related parties doing business in either Alabama or other States whose taxation of royalty income mirrors that of Alabama. Accordingly, Alabama's "add-back" statute should be struck down.

## ARGUMENT

### I. BACKGROUND

VFJ Ventures, Inc. ("VFJ") is a domestic manufacturer and seller of jeans that are sold under the brand names of Lee® and Wrangler®. During the tax year at issue, VFJ had two distribution facilities and a "cutting" facility in Alabama with approximately 600 employees. VFJ licensed the use of several trademarks from the H.D. Lee Company, Inc. ("Lee")

and Wrangler Clothing Corp. ("Wrangler") in its national manufacturing and marketing operations. Lee and Wrangler are among the direct and indirect subsidiaries of VF Corporation, headquartered in Greensboro, North Carolina, and are related subsidiaries to VFJ. They also serve as intangible management companies that, among other things, maintain, protect, and regulate the Lee and Wrangler trademarks. For the tax year at issue, Lee and Wrangler charged VFJ an arm's-length royalty for the right to use their trademarks, and Lee and Wrangler also licensed those trademarks to third parties. On its 2001 Alabama corporate tax return, VFJ claimed a deduction for the royalty payments paid to Lee and Wrangler.

On audit, the Alabama Department of Revenue invoked the Alabama "add-back" statute, Ala. Code 1975 § 40-18-35(b), and asserted that the Lee and Wrangler royalty payments — properly deducted in the computation of VFJ's separate company federal taxable income — were subject to add-back and therefore includible in Alabama taxable income. Further, the Department determined that the statutory exceptions to the "add-back" requirement were inapplicable.

Although the trial court ruled in VFJ's favor, the Alabama Court of Civil Appeals reversed. VFJ appealed to the Alabama Supreme Court on the ground that the "add-back" statute violated the Commerce Clause of the Constitution because it was discriminatory and did not fairly apportion VFJ's income. The Alabama Supreme Court rejected VFJ's constitutional challenges and affirmed the judgment of the Alabama Court of Civil Appeals. *Ex Parte VFJ*

*Ventures, Inc. (Surtees v. VFJ Ventures, Inc.)*, No. 1070718 (Ala. Sept. 19, 2008).

## II. STATUTORY OVERVIEW

### A. Determining State Taxable Income

Under the Constitution, States enjoy considerable latitude in developing their taxing schemes. Each policy choice a State makes, however, carries with it certain limitations and restrictions to ensure its constitutionality. For example, a State may elect to combine “unitary business enterprises” generally without regard to the group’s structure. In calculating the portion of the group’s income subject to tax within its border, however, the State must subject that unitary tax base to a constitutionally permissible apportionment formula. Alternatively, a State may adopt a “separate company” reporting scheme that respects the separate existence of the individual members of a corporate group.

Alabama has followed this latter course. Thus, all corporations doing business in Alabama must generally file separate company corporate income tax returns in the State — even if the corporation is included in a consolidated federal income tax return. Ala. Code 1975 § 40-18-39(a). More specifically, Alabama has chosen not to allow or require “the filing of a combined income tax return under the unitary business concept.” Ala. Code 1975 § 40-18-39(i).<sup>2</sup>

---

<sup>2</sup> Although not required, groups of corporations meeting the definition of an “Alabama affiliated group” may elect to file a consolidated Alabama corporate income tax return that includes only those affiliated corporations having nexus in Alabama. Ala. Code 1975 § 40-18-39(c). “However, under no circumstances may the Department of Revenue compel a taxpayer to

Instead, pursuant to Alabama's separate company reporting methodology, the Alabama taxable income of each member of a corporate group is calculated independently. As a direct consequence of this policy decision, transactions with affiliated corporations that would generally be "eliminated," *i.e.*, offset, in a federal consolidated income tax return (and in unitary combined returns required by other states), are not eliminated in the computation of a corporation's Alabama separate company taxable income. Ala. Code 1975 § 40-18-31.

Computation of "taxable income" for state corporate income tax purposes generally commences with a taxpayer's federal taxable income, followed by various additions and subtractions peculiar to each State's taxing regime. After the adjustments, the State applies its particular apportionment and allocation formula to determine its respective share of the corporation's taxable income. States vary considerably in the type and extent of the adjustments made to federal taxable income as well as in their apportionment formulae.

Alabama follows this general approach to the calculation of state taxable income. Specifically, "the term 'taxable income' means federal taxable income without the benefit of federal net operating losses plus the additions prescribed and less the deductions and adjustments allowed by this chapter and as allocated and apportioned to Alabama." Ala. Code 1975 § 40-18-33.

---

file an Alabama consolidated return if the taxpayer has not so elected." Ala. Code 1975 § 40-18-39(c)(1).

## B. Alabama's "Add-Back" Statute

Ala. Code 1975 § 40-18-35(b) requires corporate taxpayers to "add-back" to their federal taxable income otherwise deductible interest and intangible expenses paid to or incurred with respect to related members. Specifically:

*For purposes of computing its taxable income, a corporation shall add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions, with one or more related members, except to the extent the corporation shows, upon request by the commissioner, that the corresponding item of income was in the same taxable year: a. subject to a tax based on or measured by the related member's net income in Alabama or any other state of the United States or b. subject to a tax based on or measured by the related member's net income by a foreign nation which has in force an income tax treaty with the United States, if the recipient was a "resident" (as defined in the income tax treaty) of the foreign nation. (Emphasis added.)*<sup>3</sup>

---

<sup>3</sup> Similar provisions have been enacted in approximately 20 other states. See Ark. Code Ann. § 26-51-423(g)(1) ("A deduction . . . for interest or intangible-related expenses paid by the taxpayer to a related party shall be allowed only if: (A) The interest or intangible-related income received by the related party is subject to income tax imposed by the State of Arkansas, another state, or a foreign government . . ."); accord Ga. Code Ann. § 48-7-28.3(d)(2); 35 Ill. Comp. Stat. 5/203(a)(2)(D-18); Ind. Code § 6-3-2-20(c)(2); Ky. Rev. Stat. Ann. § 141.205(3)(b); Mich. Comp. Laws § 208.1201(2)(f)(ii); Ohio Rev. Code Ann.

Applying its "add-back" statute, Alabama denied VFJ a deduction for the arm's-length royalties paid to Lee and Wrangler as "certain intangible expenses and interest expenses with a related member."

### **III. THE ALABAMA ADD-BACK STATUTE VIOLATES THE COMMERCE CLAUSE BY IMPERMISSIBLY TAXING INCOME BEYOND ALABAMA'S CONSTITUTIONAL REACH**

Within boundaries established by the Commerce Clause and Due Process Clause, a State is free to construct its own taxing system. U.S. Const. art. I, § 8, cl. 3 and U.S. Const. amend. XIV, § 1. Once chosen, however, States must operate within and be consistent with the confines of that structure and the limitations imposed by this Court's rulings. Some States have chosen to adopt taxing regimes under which a taxpayer's entire unitary group of corporations is required to be included in a single combined corporate tax report. *See e.g.*, California (Cal. Rev. & Tax Code § 25101); Maine (Me. Rev. Stat. Ann. § 5220(5)). Under a unitary combined system, all members of a unitary group of taxpayers (including those without nexus in the state) are included in a combined report and intercompany transactions between group members are eliminated. Other

---

§§ 5733.042, 5733.055(A)(2); Va. Code Ann. § 58.1-402(B)(8)(a)(1). Several jurisdictions allow the deduction only if the related payments are subject to tax above a certain rate. *See* Conn. Gen. Stat. § 12-218(c); D.C. Code § 47-1803.03(a)(19)(B); Md. Code Ann. Tax-Gen. § 10-306.1(c); Mass. Gen. Laws ch. 63, § 31I; 830 Mass. Code Regs. 63.31.1; R.I. Gen. Laws § 44-11-11(f)(3). Two States allow the deduction only if the related payments are subject to tax in those States. *See* N.J. Stat. Ann. § 54:10A-4.4; N.J. Admin. Code § 18:7-5.18(b)(3); N.C. Gen. Stat. § 105-130.7A.

States have enacted systems under which each corporation must file a separate state return regardless whether the corporation files a consolidated federal return. See e.g., Maryland (Md. Code Ann. Tax-Gen. § 10-811); Pennsylvania (72 P.S. § 7404).

Alabama, as is its right, has adopted a state taxing regime that imposes corporate income tax liability on a "separate company" basis. A direct consequence of that policy choice is the requirement that Alabama must recognize the separate existence of individual corporations. Additionally, it is within this separate company reporting context that Alabama's "add-back" statute must be tested by and withstand scrutiny under the Commerce Clause and Due Process Clause. Regrettably, Alabama's "add-back" statute fails that scrutiny.

A State may not tax value outside its borders. *E.g.*, *Connecticut General Life Ins. Co. v. Johnson*, 303 U.S. 77, 80-81 (1938). Such taxation is forbidden because the "fundamental purpose of the [Commerce] Clause is to assure that there be free trade among the several States," *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 335 (1977), and because extraterritorial taxation offends fundamental notions of due process and constitutes an "unreasonable clog upon the mobility of commerce," *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935).

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), this Court established a four-prong test for determining whether a state tax statute violates the Commerce Clause — that is to say, whether it impermissibly reaches extraterritorial values. Specifically, a tax will be sustained only if (1) it is applied to an activity with a substantial nexus with the taxing State, (2) it is fairly apportioned, (3) it does

not discriminate against interstate commerce, and (4) it is fairly related to the services provided by the State. *Id.* at 279. Three decades later, *Complete Auto Transit* remains the decisional framework for determining whether a tax unduly infringes on interstate commerce. See, e.g., *Trinova Corp. v. Michigan Department of Treasury*, 498 U.S. 358, 372-73 (1991); *Exxon Corp. v. Department of Revenue*, 447 U.S. 207, 227-28 (1980).

The four tests enunciated by the Court in *Complete Auto Transit* are not wholly independent of one another, but rather represent four ways of answering the same question — whether a State is attempting to tax “value outside its borders.” See *Connecticut General Life Ins. Co.*, 303 U.S. at 80-81. Thus, while VFJ itself clearly had “substantial nexus” with the State of Alabama, that finding alone does not give the State license to deny VFJ a deduction for the arm’s-length royalties it properly paid to Lee and Wrangler. Rather, a review of *Complete Auto Transit*’s other tests is required.

Applying the fair apportionment test can be problematic. This Court has rightly observed that dividing income among the several States bears some resemblance to “slicing a shadow.” *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 192 (1983).<sup>4</sup>

---

<sup>4</sup> Although the terms “allocation” and “apportionment” are often used interchangeably in respect of the division of income among various jurisdictions, “allocation” properly refers to the “attribution of a particular type of income to a designated State, [and] ‘apportionment’ refers to the division of the tax base by formula.” JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION I: CORPORATE INCOME AND FRANCHISE TAXES* ¶ 9.01, at 9-7 n.2 (3d ed. 2008). A typical “three-factor” formula — similar to the one used by the State of Alabama in this case — compares (i) the taxpayer’s property, payroll, and sales (re-

Absolute consistency, even among taxing authorities using the same apportionment formula, "may just be too much to ask," *id.*, but there are constitutional limits on a State's use of an apportionment formula. In other words, a balance must be struck between the State's power to tax and the taxpayer's legitimate right to protection from overreaching taxing authorities. It is for this Court to ensure that the balance is a reasonable one.<sup>5</sup> If the State has not "given anything for which it can ask return" in respect of the person, property, or transaction it seeks to tax, *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940), the Commerce Clause and Due Process Clause operate as a constitutional brake upon the State's raw power to tax.

To pass constitutional muster, the apportionment formula must, first and foremost, be fair. *Container Corp.*, 463 U.S. at 169. And there must be internal consistency: "[T]he formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed." *Id.* There must also be external consistency: "[T]he factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." *Id.*

Alabama's "add-back" statute fails the test of fair apportionment because its denial of VFJ's deduction for royalties paid to Lee and Wrangler effectively

---

ceipts) within the taxing State to (ii) the taxpayer's total property, payroll, and sales. UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT (U.L.A.) §§ 9-15.

<sup>5</sup> See *Boston Stock Exchange*, 429 U.S. at 329 (the Court has a duty "to make the delicate adjustment between the national interest in free and open trade and the legitimate interest of the individual States in exercising their taxing powers").

taxes value outside the State. To be sure, Alabama could have included that royalty income in the tax base by enacting a taxing scheme requiring combined reporting, but if it did, it would have also had to take into account the various items of income and expense of all members of the taxpayer's corporate group. Having made a policy choice to tax corporations on a separate company — as opposed to a combined — basis,<sup>6</sup> Alabama may not constitutionally cherry pick items of income or expense (to include or exclude) in order to increase the taxes it exacts from multi-jurisdictional companies without making correlative adjustments to the formula used to apportion the income among Alabama and the other States.

Indeed, *amicus* TEI submits that an apportionment method that fails by design to take into account the factors that generated the apportioned income is constitutionally flawed because there can never be a "rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 436-37 (1980). The failure to provide factor representation is "inherently arbitrary," *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920), and cannot help but produce a result that reflects neither "a reasonable sense of how [the]

---

<sup>6</sup> Rather than requiring related corporations engaged primarily in the management of intangible assets to file or to be included in an Alabama corporate income tax return, the State conjured a similar result by denying an in-state operating company a royalty deduction for payments made to an intangible management company. This type of corporate combination is expressly prohibited by Alabama statute. Ala. Code 1975 § 40-18-39(c)(1) ("under no circumstances may the Department of Revenue compel a taxpayer to file an Alabama consolidated return if the taxpayer has not so elected").

income [was] generated" (as required by *Container Corp.*, 463 U.S. at 169) nor "the relative contribution of the activities in the various States [specifically, Alabama] to the production of total unitary income" (*Butler Brothers v. McColgan*, 315 U.S. 501, 509 (1942)). This Court's prior holdings teach this conclusion and common sense confirms it.

In *Mobil*, the Court acknowledged that the factor representation issue could be one of constitutional import, but did not decide the issue. 445 U.S. at 434, 441 n.15, 449. Justice Stevens, however, found the issue dispositive, concluding it was constitutionally improper to "lump huge quantities of investment income that have no special connection with the taxpayer's operations in the taxing State into the tax base" without taking into account the factors that produced that income. 445 U.S. at 459 (Stevens, J., dissenting). Justice Stevens explained:

Unless the sales, payroll, and property values connected with the production of income by the payor corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will *inevitably* cause Mobil's Vermont income to be overstated.

*Id.* at 461 (emphasis added). Eleven years later, the Maine Supreme Court addressed this issue directly and held that the lack of factor representation was constitutionally fatal to a taxing scheme:

[Without factor representation,] [t]he ineluctable result is that more of the business activity of the unitary business is attributed to [the State] than is the actual case. Thus, the income taxable by [the State] under the Assessor's formula does not

truly reflect [the corporation's] connection with [the State] and fails to meet the test of fairness required by the due process clause.

*Tambrands, Inc. v. State Tax Assessor*, 595 A.2d 1039, 1044 (Me. 1991).

The lack of a rational relationship between VFJ's activities in Alabama and the royalty income that Alabama is seeking to tax is underscored by the amount of income subject to tax under Alabama's "add-back" statute being dependent on where the recipient of the relevant royalty payments is located and the taxing regime in place in that jurisdiction. For example, if Lee and Wrangler were located in Maryland (a separate company reporting jurisdiction that taxes royalties) and apportioned all of their income to Maryland, the royalties paid by VFJ to Lee and Wrangler would not be subject to Alabama's add-back statute — effectively reducing VFJ's income subject to tax in Alabama. Because Lee and Wrangler operate in Delaware (a State that exempts royalty income from state income taxation), however, Alabama seeks to tax those same royalties by adding them back in the calculation of VFJ's income. This increase in income subject to tax has no relationship to VFJ's activities in Alabama.

In short, States must accept both the benefits and burdens of the tax policy choices their legislatures have made. They may not adopt a "one from column A and one from column B" approach to state taxation in order to tax value outside their borders. The Commerce Clause demands more.

Under the third prong of *Complete Auto Transit*, to survive constitutional challenge a State tax must not discriminate against interstate commerce. This

prohibition on discrimination was borne of fear of “economic protectionism — that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors.” *New Energy Co. v. Limbach*, 486 U.S. 269, 273-74 (1988).

This Court has defined “discrimination” for Commerce Clause purposes as “differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.” *Oregon Waste Systems, Inc. v. Department of Environmental Quality of Oregon*, 511 U.S. 93, 99 (1994). Where a state statute is found to be discriminatory, it is “virtually *per se* invalid.” *Id.* A discriminatory statute will only pass constitutional muster if it “advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.” *Id.* at 101 (internal quotation marks omitted).

This Court has struck down laws in several states, including Alabama, on the ground that they discriminate against interstate commerce. See e.g., *South Central Bell Tel. Co. v. Alabama*, 26 U.S. 160 (1999) (invalidating a state franchise tax that unconstitutionally favored Alabama corporations over out-of-state corporations); *Oregon Waste Systems, Inc. v. Department of Environmental Quality of Oregon*, 511 U.S. 93 (1994) (finding unconstitutional a waste disposal surcharge imposed at different rates for waste generated within and without the State).

Most recently, in *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000), California imposed a corporate franchise tax on businesses for the privilege of doing business in the State. Taxpayers were required to deduct business interest expense from business income in calculating net taxable income. California also required taxpayers to offset their

business interest expense, dollar for dollar, with non-business income not allocable to the State. Thus, out-of-state corporations were compelled to reduce their interest deduction by the amount of their nontaxable income, without regard to whether the interest expense was related to the nontaxable income.

In striking down the interest offset, the trial court in *Hunt-Wesson* succinctly put the matter this way: "[T]he offset provisions treat two corporations in an identical business transaction differently based solely on their state of domicile, which difference results in increased taxes for foreign corporations." *Hunt-Wesson, Inc. v. Franchise Tax Board*, No. 976628, Cal. Superior Ct., City and County of San Francisco, Dep't 17, June 6, 1997, *rev'd*, No. A079969, Cal. Ct. App., 1st Dist., Div. 3, Dec. 11, 1998 (unpublished). This Court unanimously agreed: "Because California's [interest deduction] offset provision is not a reasonable allocation of expense deductions to the income that the expense generates, it constitutes impermissible taxation of income outside its jurisdictional reach." 528 U.S. at 468. Consequently, the Court held that the provision "violates the Due Process and Commerce Clauses of the Constitution." *Id.*

Here, Alabama's statute is equally infirmed. The "add-back" statute unconstitutionally discriminates in favor of royalties paid to related parties doing business in either Alabama or other States whose taxation of royalty income mirrors that of Alabama. For example, if a taxpayer pays a royalty to a related corporation doing business in Wyoming, that royalty must be added back in the calculation of the taxpayer's Alabama taxable income since Wyoming does not impose a corporate income tax. If that same taxpayer paid those same royalties to a related

corporation doing business in Alabama, no add-back would be required under Alabama's statute.

### CONCLUSION

For the foregoing reasons, the Court should grant the petition for a writ of certiorari and reverse the decision below.

Respectfully submitted,

ELI J. DICKER \*  
DANIEL B. DE JONG  
TIMOTHY J. MCCORMALLY  
TAX EXECUTIVES INSTITUTE, INC.  
1200 G Street, N.W., Suite 300  
Washington, D.C. 20005  
(202) 638-5601

\* Counsel of Record

*Counsel for Amicus Curiae  
Tax Executives Institute, Inc.*

February 23, 2009